Supreme Court, U.S.
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In the Supreme Court

of the United States

OCTOBER TERM, 1974

No. 74-1651

RICHARD A. CLARK, JAMES H. EVANS, WESTON M. LENNOX, DAVID A. MOFFAT, SAMUEL L. SAVIDGE, GEORGE L. ZIMMERMAN and HELEN D. BLOOMFIELD,
Petitioners,

v.

H. R. WATCHIE and SHEILA WATCHIE, his wife, H. R. WATCHIE & ASSOCIATES, INC., a Washington corporation, E. JOSEPH McCAMBRIDGE and JANE DOE McCAMBRIDGE, his wife, GENE LYNN and JANE DOE LYNN, his wife,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

Petitioners respectfully pray for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit to review the portion of the judgment and opinion of that court which affirmed a district court's denial of class action status to petitioners' securities fraud suit against respondents.

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OPINIONS IN THE COURTS BELOW

Pretrial proceedings in the district court were referred to a bankruptcy referee as a special master. He filed a report which concluded that the suit did not qualify as a class action. The district court then denied petitioners' motion for class action status. That determination was affirmed by the court of appeals. The report of the special master and the order of the district court are not reported. The pertinent portion of the opinion of the court of appeals appears at 19 FR Serv2d 1496. Copies of the special master's report, the district court order and the opinion of the court of appeals are included in the appendix to this petition.

JURISDICTION OF THIS COURT

The judgment of the court of appeals was dated and entered April 2, 1975. The only petition for rehearing was a petition by respondents with respect to matters that are not material to this petition to this court. The petition for rehearing was denied by order dated June 5, 1975 and docketed June 6, 1975. There has been no application for any extension of time within which to petition for certiorari. This court has jurisdiction to entertain this petition pursuant to the provisions of 28 U.S.C. § 1254(1).

THE QUESTIONS PRESENTED FOR REVIEW

1. Where there is a single scheme to defraud which

involves the sale of securities without disclosure of adverse facts about them, may there be a class action on behalf of all defrauded investors provided that the common issues predominate over the individual issues, atlhough the facts concealed are not established to be identical as to each investor?

2. Under Rule 23 of the Rules of Federal Procedure, does a district court have discretion to deny class status to a suit under S.E.C. Rule 10b-5 for the reason that the securities were sold with oral representations, if there is a common core of fraudulent conduct and the questions of law and of fact that are common to all members of the class clearly predominate over questions effecting only individual members?

RULES AND REGULATIONS INVOLVED

This petition involves Rule 23 of the Rules of Civil Procedure for the United States District Courts and S.E.C. Rule 10b-5, 17 C.F.R. § 240, 10b-5. The text of those rules are set out in the appendix to this petition.

STATMENT OF THE CASE

Certain purchasers of limited partnership units in a multi-million dollar land syndicate (Cougar Mountain partnership) filed a class action complaint on behalf of all purchasers of the units. Petitioners alleged that there was a conspiracy and scheme to defraud members of the public by the sale of those partnership

units in violation of S.E.C. Rule 10b-5. The district court therefore had jurisdiction of the action pursuant to § 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 78aa.

Respondent H. R. Watchie became the general partner of the Cougar Mountain partnership. H. R. Watchie & Associates, Inc. (Associates) was the underwriter of the sale of the partnership units. Respondents Gene Lynn and E. Joseph McCambridge are claimed to have been controlling persons of Associates, aiders and abettors of it and participants in the conspiracy and in the sale of the units (A 30, 57-59).*

The alleged conspiracy included a plan of respondents to create a real estate syndicate that would pay several million dollars to buy real estate at inflated prices. The land was located in an area where Associates allegedly had created an artificial real estate market. That market is claimed to have been created by inducing the buying and selling of tracts of unimproved land between small syndicates organized by Associates. The syndicates were made up of unsophisticated investors. They relied upon Associates and its personnel for decisions as to what land they should buy, what they should pay for it, when they should sell it and how much they should charge for it. In many cases the investors did not even see the land which their syndicate purchased (A 42-43, 61).

* References are to pages of the appendix. It is separately presented.

Most of the sales by one such syndicate to another were at prices which were exactly double the amount that the seller had paid for the property. Associates received a 10% commission on each such sale. The ultimate total amount of commissions on repeated sales of a tract between Associates dominated syndicate groups sometimes approached or exceeded the price originally paid to a stranger for the property (A 45-46).

Petitioners claim that a real estate bubble had been created and that a main purpose of the conspiracy was to prevent the bubble from bursting. The new multi-million dollar syndicate would buy the properties of the various small syndicates, usually at double the prices paid for them by the small groups of investors. The property would then be held until anticipated increases in market values made the land worth the doubled and redoubled prices. Petitioners contend that respondents assumed that pooling all of the real estate interests in one limited partnership would make it impractical for any investor to determine if the prices paid for partnership properties were reasonable or excessive (A 44-49).

The sale of all the properties to the partnership would also result in additional 10% real estate commissions for Associates. That would enable it to pay large sums of money to the individual respondents (A 47).

It is claimed that the plan was also calculated to eliminate any risk of legal action by earlier investors

who had been induced to pay doubled prices for property. Those purchasers would themselves receive double their purchase prices by resales to the Cougar Mountain partnership (A 47-48, 62).

It allegedly was part of the plan of the conspirators that units of limited partnership interests in the new syndicate would be sold to members of the public without disclosure of the facts relating to respondents' alleged intent to use the partnership to "bail out" the earlier investors. Petitioners further claim that as part of the plan other material matters would be and were concealed from purchasers of the partnership units and that false statements and half truths would be and were used in the sale of the units (A 50-57, 63-70).

The sales program consisted of a series of meetings at clubs and restaurants in the Seattle area. Mr. Watchie would give a memorized sales presentation and then answer questions. Following the memorized presentation by Watchie prospective investors would be solicited by salesmen employed by Associates on a commission basis. They were instructed to quote or paraphrase Mr. Watchie's memorized presentation but not to add to it (A 70).

In moving for class action status petitioners made it clear that in establishing liability they would not rely upon false statements, if any, of the salesmen.

> "Defendants contend that there should be no class action because some of the oral representations of salesmen may have been false and may have varied from one investor to another. Plain-

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> tiffs' attorney has represented in open court, and now confirms, that plaintiffs do not rely upon any such misrepresentations, if they occurred. Plaintiffs' reliance is upon concealment of the same facts from all members of the class; misrepresentations in the written material given in identical form to all investors and upon half truths included in the memorized sales presentation of H. R. Watchie that was given at all of the sales meetings." (R. 455-456).

The sale of the limited partnership units in the new land syndicate proved to be successful. Large sums of money were raised. The partnership paid $5,500,000 for some 43 properties which had been acquired by the small syndicates for a total sum of $2,800,000 during the three years preceding the formation of the partnership. Twenty-six of the properties were sold to the new partnership at exactly double the prices which the smaller syndicates had paid for the same tracts (A. 26).

The Securities and Exchange Commission obtained an injunction against Associates restraining collection of further installment payments on the Cougar Mountain limited partnership units until there was full disclosure of material facts to the limited partners. An appropriate report was prepared by Associates under the observation of the staff of the Securities and Exchange Commission. Copies of the disclosure report were distributed to the limited partners.

Some time later this private civil action was filed as a class suit on behalf of the purchasers of the partnership units.

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ARGUMENT

Summary of Argument

The decision of the court of appeals in this proceeding permits those who sell securities by fraud to insulate themselves from class suits by simply causing oral representations to be made to their victims. The correctness of that ruling is an important matter that has not been determined by this court. The decision of the Ninth Circuit is in conflict with a decision of the Tenth Circuit and conflicts in principle with decisions of the Second Circuit.

Important Question of Federal Law Not Yet Settled by This Court

The importance of class actions in enforcement of federal securities laws was recognized by the Second Circuit in *Green* v. *Wolf Corporation et al*, 406 F.2d 291, 295, cert. den. 395 U.S. 977 (1969):

> "We are mindful that the serious and troublesome question as to when to allow a class action under 10b-5 is of great importance. This is so because '[t]he ultimate effectivenes of the federal remedies when the defendants are not prone to settle may depend in large measure on the applicability of the class action device.' 3 Loss, Securities Regulation 1819 (2d ed. 1961)"

The Ninth Circuit decision in this case effectively withdraws any class action remedy from defrauded securities purchasers who received oral representations from the seller or the seller's agents or salesmen.

The Court of Appeals for the Ninth Circuit held:

> "Appellants must show, as a condition to class status, that any misrepresentations or non-disclosures were common to the class. They have not shown that the alleged misrepresentations and non-disclosures involved every limited partner."

Subdivision (b)(3) of Rule 23 of the Federal Rules of Civil Procedure requires a finding:

> ". . . that the questions of law or fact common to the members of the class predominate over any questions effecting only individual members."

The Ninth Circuit now has added an additional requirement with respect to suits under S.E.C. Rule 10b-5. The class representative must also establish that any misrepresentations or non-disclosures were common to the class. This is probably impossible for a class that consists of dozens or hundreds of persons. It becomes patently impossible if some years elapse before the fraud is discovered.

It is respectfully submitted that the correctness of this additional requirement for a 10b-5 class suit presents an important question of federal law which has not been, but should be, settled by this court. If the ruling below is permitted to stand, any dishonest person who devises a scheme to defraud, which involves the sale of securities, can effectively insulate himself from danger of a class action suit on behalf of his victims by causing them to receive oral representations about the securities.

Under the Ninth Circuit decision, the class action

for violation of Rule 10b-5 continues to be an effective (perhaps overly effective) weapon in certain circumstances, such as a suit against a national accounting firm which makes an error of judgment in its footnoting of a financial statement. Unlike the thief who deliberately carries out a scheme to defraud, the accounting firm cannot protect itself from class suits by causing the use of oral representations. Yet, if there is to be any difference in the degree of exposure to a meaningful 10b-5 lawsuit, which must be brought as a class action, the difference should favor the honest man rather than the scoundrel.

The Ninth Cricuit has misconstrued Rule 23. That rule does not require disclosures or nondisclosures which are identical for every class member in a 10b-5 suit. The rule merely requires that common issues of law or of fact predominate over individual issues. There is express provision for sub-classes in the event that class members do not all fit into exactly the same mold.

A correct determination as to whether individual or common issues predominate requires examination of all of the issues in a class suit. There is no simple formula. One may not say that written representations mean that common issues predominate but that existence of oral representations establishes that individual issues predominate. In many 10b-5 actions the representations or omisisons will not result in any important issue.

An example is the relatively common situation

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where a rigged market is created for the freely tradable but worthless stock of a shell corporation. In a suit by defrauded buyers the predominate issue is not whether the worthlessness of the stock was or was not disclosed to some or all of the investors. No one will contend that it was disclosed to any purchaser. Most of the defendants are likely to claim instead that no such disclosure would have been proper for them, because they believed that the stock was valuable. The true issues in the action will concern the overall scheme to defraud, any asserted favorable prospects of the corporation, the alleged rigging of the market and the identity and responsibility of the people who were involved, in one way or another, in the acquisition of a large block of the worthless stock and its eventual resale at substantial prices.

Petitioners submit that the Court of Appeals for the Ninth Circuit has failed to heed the frequent admonition of this court that courts must be alert to provide effective remedies for violations of the securities acts. *SEC* v. *Capital Gains Bureau*, 375 U.S. 180, 195 (1963); *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 386 (1970). On the contrary, the ruling of that court of appeals to some extent threatens the effectiveness of the private action as one means of enforcing the policy of the United States with respect to the purchase and sale of securities. There appears to be analogy to the situation in *Perma Life Mufflers* v. *International Parts Corp.*, 392 U.S. 134, 136 (1968):

"Because these rulings by the Court of Ap-

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peals seemed to threaten the effectiveness of the private action as a vital means for enforcing the antitrust policy of the United States, we granted certiorari."

Direct Conflict with Decision of Tenth Circuit

The decision of the Ninth Circuit in this matter is in conflict with the Tenth Circuit decision in *Esplin* v. *Hirschi*, 402 F.2d 94 (1968), cert. denied 394 U.S. 928 (1968). *Esplin*, like this case, was a private action under S.E.C. Rule 10b-5 for fraudulent sale of securities by oral representations. In both cases the district judges held that because the oral representations were made the individual issues predominated and the suits should not proceed as class actions.

In each case there was an allegation of complete failure to disclose certain material facts to any purchaser of the securities. The Tenth Circuit held that the common questions "were sufficiently predominate for a 23(b)(3) type of class action." (402 F.2d at 100). That court recognized that the representations which had been made were oral.

> "It was undisputed that defendants did not deliver a prospectus to any of the investors . . ." (402 F.2d at 96)
>
> . . . . .
>
> "We are thus faced with the question of whether the trial of Rule 23 in not allowing this class action to proceed. Undoubtedly the possibility exists that there will be questions of individual oral misrepresentation to each of the potential

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> plaintiffs relating to their inducement in buying the securities and in lulling them sufficiently to toll the statute of limitations. On the other hand, an examination of the Second Amended Complaint filed by the plaintiffs shows that the real basis of their allegations concerns the failure of the defendants to make any representations concerning relevant and material facts, i.e., certain omissions of material facts common to all purchasers. . . ." (402 F.2d at 98-99)

The contrary decision of the Ninth Circuit in this proceeding affirmed the action of the district court in denying petitioners' class action motion. The court of appeals went further. It established a requirement for securities fraud class suits which will have the practical effect of preventing such suits in the Ninth Circuit whenever securities are sold by means of oral representations or by means of written material that is not identical for each purchaser.

Petitioners respectfully submit that the conflict should be resolved by this court.

Conflict in Principle with Decisions of the Second Circuit

In *Green* v. *Wolf Corporation, et al.*, supra, (406 F.2d at 300), the Second Circuit held that where there was a common course of conduct, designed to continually manipulate the market price of stock, there was a violation of section 10b-5 which constituted a common question under Rule 23. The fact that there were some differences in the written representations that

were made to different members of the class did not prevent the use of Rule 23.

> "If we were to deny a class action simply because all of the allegations of the class do not fit together like pieces in a jigsaw puzzle, we would destroy much of the utility of Rule 23."

Green v. *Wolf Corporation* did not involve oral representations. Yet it presents a conflict in principle with the Ninth Circuit decision in this proceeding. The Second Circuit requires that the common issues predominate but, unlike the Ninth Circuit, it permits divergence in the representations if other factors cause the common issues to predominate.

A more recent Second Circuit decision makes it clear that, in that circuit, securities fraud cases may be recognized to involve an elaborate scheme to defraud and that not all such suits should be deemed to be based primarily upon misrepresentations or concealment of facts. See: *Competitive Associates, Inc.* v. *Laventhol, Krekstein, Howarth & Howarth*, — F.2d — (1975), C.C.H. Fed. Sec. L. Rep. ¶ 95,090, page 97,866.

> "Not every violation of the anti-fraud provisions of the federal securities law can be, or should be, forced into a category headed 'misrepresentations' or 'nondisclosures'. Fraudulent devices, practices, schemes, artifices and courses of business are also interdicted by the securities laws. In the case before us, plaintiff has charged the accounting defendants not only with affirmative misrepresentations in the financial statements, but also with a failure to disclose the true

financial condition of Takara Partners and the alleged receipt of payoffs in return for its certification; furthermore, both misrepresentations and omissions are alleged to be only one aspect of an elaborate scheme to defraud. Under these circumstances, plaintiff need only show causation in fact; in order to do so plaintiff should have the opportunity to prove, but is not required to prove, that it saw, or directly relied upon, the financial statements certified by the accounting defendants. *Cf. Hochfedler* v. *Ernst & Ernst*, 503 F.2d 1100, 1115 (7th Cir. 1974)."

While there are great factual differences between *Green* v. *Wolf Corporation* and the instant matter it is respectfully submitted that the securities fraud class action concepts demonstrated in the one are so contrary to those shown in the other that the conflict should be resolved by this court.

This Proceeding is Appropriate for Use in Resolution of the Questions Presented

If the court should conclude that either or both of the questions presented in this petition are of sufficient importance to justify resolution by this court, the facts in this proceeding are well suited to provide opportunity for definitive answers to the questions.

Petitioners claim, and propose to prove, that the representations that were made (and those that were not made) in the sale of the partnership units followed a common pattern. Investors were given a copy of the articles of limited partnership. It allegedly con-

tains some false statements. They next listened to a memorized speech by Watchie and then were approached by salesmen who were instructed to quote or paraphrase Mr. Watchie's speech but not to add to it. The salesmen worked on commission. They may have had temptation to embellish but they had no motivation to volunteer information that would deter prospects from buying the units. Further, petitioners expressly waived any right to rely on false statements, if any, made by the salesmen.

No respondent contends that the investors were advised that Associates had created an artificial market in real estate and that the Cougar Mountain partnership was planned and created in order to "bail out" the investors in that artificial market by purchasing their properties at doubled and redoubled prices. Respondents deny any artificial market or "bail out." They claim that all property sales were at fair prices.

When the case is tried the real issues which will require most of the court's time and attention will not be issues of misrepresentation or non-disclosure. The major issues will include: (a) Was there an artificial market? (b) Was there a conspiracy to defraud, and if so, who joined in it? (c) Who were the controlling persons of Associates when the sale of the partnership units was planned and accomplished? (d) Who, if anyone, aided and abetted Associates? (e) What was the reasonable value of each of the 65 parcels of property purchased by the Cougar Mountain partnership? (f) Which, if any, of the statements

in the printed copies of the partnership articles were false?

The above list does not include all of the important issues which must be resolved at a trial. Even that brief listing of disputed matters makes it clear that misrepresentation and non-disclosure matters are dwarfed by the other issues in the action.

CONCLUSION

A writ of certiorari should issue to review the judgment and opinion of the Ninth Circuit.

Respectfully submitted,

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June 27, 1975.

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APPENDIX

Text of SEC Rule 10b-5
17 C.F.R. § 240, 10b-5

Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of a national securities exchange,

(1) to employ any device, scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

Text of Rule 23 of the Rules of Civil Procedure for the United States District Courts

(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impractic-

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able, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

(b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:

(1) the prosecution of separate actions by or against individual members of the class would create a risk of

(A) inconsistent or varying adjudications with respect to individual members of the class which would establish incompatible standards of conduct for the party opposing the class, or

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interests of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

(2) the party opposing the class has acted or refused to act on grounds generally applicable to the class, thereby making appropriate final injunctive relief or corresponding declaratory relief with respect to the class as a whole; or

(3) the court finds that the questions of law or fact common to the members of the class predominate

over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (B) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (D) the difficulties likely to be encountered in the management of a class action.

(c) Determination by Order Whether Class Action to be Maintained; Notice; Judgment; Actions Conducted Partially as Class Actions.

(1) As soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained. An order under this subdivision may be conditional, and may be altered or amended before the decision on the merits.

(2) In any class action maintained under subdivision (b)(3), the court shall direct to the members of the class the best notice practicable under the circumstances, including individual notice to all members who can be identified through reasonable effort. The notice shall advise each member that (A) the court will exclude him from the class if he so requests by a specified date; (B) the judgment, whether favorable or

not, will include all members who do not request exclusion; and (C) any member who does not request exclusion may, if he desires, enter an appearance through his counsel.

(3) The judgment in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class. The judgment in an action maintained as a class action under subdivision (b)(3), whether or not favorable to the class, shall include and specify or describe those to whom the notice provided in subdivision (c)(2) was directed, and who have not requested exclusion and whom the court finds to be members of the class.

(4) When appropriate (A) an action may be brought or maintained as a class action with respect to particular issues, or (B) a class may be divided into subclasses and each subclass treated as a class, and the provisions of this rule shall be construed and applied accordingly.

(d) Orders in Conduct of Actions. In the conduct of actions to which this rule applies, the court may make appropriate orders: (1) determining the course of proceedings or prescribing measures to prevent undue repetition or complication in the presentation of evidence or argument; (2) requiring, for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all

of the members of any step in the action, or of the proposed extent of the judgment, or of the opportunity of members to signify whether they consider the representatition fair and adequate, to intervene and present claims or defenses, or otherwise to come into the action; (3) imposing conditions on the representative parties or on intervenors; (4) requiring that the pleadings be amended to eliminate therefrom allegations as to representation of absent persons, and that the action proceed accordingly; (5) dealing with similar procedural matters. The orders may be combined with an order under Rule 16, and may be altered or amended as may be desirable from time to time.

(c) Dismissal or Compromise. A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

Opinion of Court of Appeals

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

RICHARD A. CLARK, JAMES H. EVANS, WESTON M. LENNOX, DAVIS A. MOFFAT, SAMUEL L. SAVIDGE, GEORGE L. ZIMMERMAN and HELEN D. BLOOMFIELD,

Plaintiffs-Appellants,

v.

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Defendants-Appellees.

No. 74-1382

OPINION

[April 2, 1975]

On Appeal from the United States District Court for the Western District of Washington

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Before: CHAMBERS and WRIGHT, Circuit Judges, and THOMPSON,* District Judge.

THOMPSON, District Judge:

This appeal is from a summary judgment in favor of Defendants-Appellees. The district court held that the doctrines of res judicata and collateral estoppel preclude a 10b-5 suit subsequent to a state court judgment in a partnership accounting suit. The Court also denied class status to Plaintiffs-Appellants. We reverse the first determination and affirm the second.

H. R. Watchie was President of H. R. Watchie & Associates. In 1961, Watchie formed a large land syndicate limited partnership known as Cougar Mountain Associates. H. R. Watchie was the general partner of Cougar Mountain Associates and H. R. Watchie &

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* Honorable Bruce R. Thompson, United States District Judge for the District of Nevada, sitting by designation.

Associates was its management corporation and real estate broker.

Limited partnership units were to be sold to the public. The partnership agreement provided for six hundred limited partnership units. Each limited partner was to contribute $20,000 for each unit; $5,000 down and yearly assessments of $1,750 up to the total as required. Prospective purchasers were invited to clubs and restaurants to hear a sales talk by H. R. Watchie. After Watchie's presentation, commissioned salesmen met with the prospective purchasers to show them property which the partnership planned to buy and to persuade them to purchase partnership units. Each of the apellants purchased one or more units.

Cougar Mountain Associates ultimately purchased or entered into contracts to purchase sixty-six parcels of property. Watchie had an ownership interest in forty-three of those parcels. Some of the parcels of property purchased by the partnership were purchased from Watchie's brokerage customers.

In 1967, because of its precarious financial condition, the partnership was forced to pledge all its assets to borrow money at high interest rates. CMA Corporation was organized to replace Watchie as general partner of Cougar Mountain Associates. The new general partner terminated the management contract of H. R. Watchie & Associates.

On October 29, 1968, two suits—one in state court, the other in federal court—were instituted against H. R. Watchie. The state complaint alleged that

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Watchie breached his fiduciary duty to the partnership by mismanaging the partnership affairs from 1961 to 1967. The federal complaint alleged a violation of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) and Rule 10b-5, 17 C.F.R. § 240-10b-5.[1] The federal complaint alleged that Appellees, acting individually and in conspiracy, made material misrepresentations and omissions in connection with the sale of the partnership units in 1961 and 1962. Lynn, McCambridge and Gustaveson were added as defendants in the federal suit only in July, 1969.[2]

The Court found that Watchie had acted in good faith but had failed to obtain appraisals on several properties as required by the partnership agreement. Judgment was entered against him for $515,880.44, the excess of the purchase price of these properties over their fair market value.

On November 26, 1971, relying on a report of the special master, the district court denied Appellants' motion for a determination that the suit be certified as a class action. An appeal of that decision was withdrawn by Appellants.

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[1] Rule 10b-5, 17 C.F.R. § 240, 10b-5, provides in part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce * * *

"(b) To make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made * * * not misleading * * * in connection with the purchase or sale of any security."

[2] Defendant Gustaveson's motion to dismiss was granted prior to the order granting summary judgment in favor of Watchie, Lynn, and McCambridge.

On October 25, 1973, following the special master's report, the district court granted Appellees' motion for summary judgment. The master had concluded that since the issues in the state and federal cases were similar, the findings of the state court estopped the Appellants from further pursuing their federal claim.

THE RES JUDICATA/COLLATERAL ESTOPPEL EFFECT OF THE STATE JUDGMENT ON THE 10b-5 SUIT.

We must first deal with res judicata. It is only when the prior judgment does not fit into that doctrine that it is necessary to inquire into the collateral estoppel effect of the judgment. *Exhibitors Poster Exchange, Inc. v. National Screen Service Corp.*, 421 F. 2d 1313, 1316 (5th Cir. 1970).

The doctrine of res judicata will apply to preclude a second suit only if the causes of action in the two suits are identical.[3] The Securities Exchange Act of 1934, 15 U.S.C. § 78aa, gives exclusive jurisdiction to the federal courts to consider Rule 10b-5 claims.[4] In *Abramson v. Penwood Inv. Corp.*, 392 F.2d 759, 762 (2nd Cir. 1969), the Court said that a Rule 10b-5 claim "is a different cause of action from the claim

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[3] See 1B Moore's Federal Practice, ¶ 0.441(2) at 3777 (2nd Edition 1974).

[4] The Securities Exchange Act of 1934, 15 U.S.C. § 78aa, provides:

> "The district courts of the United States * * * shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder * * *."

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for breach of fiduciary duty and is one which is cognizable only in federal courts. Res judicata cannot be applied to foreclose the federal claim in this case.

Lynn and McCambridge were not parties in the state suit. We must, therefore, preliminarily consider whether they have standing to assert the defense of collateral estoppel. Under traditional collateral estoppel theory, the doctrine of mutuality of estoppel required that the party asserting the defense must have been a party to the earlier litigation. In *Blonder-Tongue Laboratories v. University of Illinois Foundation*, 402 U.S. 313, 320-328 (1971), the Supreme Court criticized and rejected the doctrine of mutuality of estoppel. Thus, Lynn and McCambridge may assert the defense.

Appellants should not, however, be collaterally estopped from asserting their 10b-5 claim against those Appellees. The master's report was premised on the notion that the 10b-5 claim was based solely on a conspiracy theory. The master reasoned, and Appellees similarly contend, that a conspiracy could not have existed given the finding of Watchie's good faith by the state court. However, even if the finding of Watchie's good faith would foreclose the determination of Watchie's involvement in a conspiracy, Lynn and McCambridge could be found to have conspired together to sell securities in violation of Rule 10b-5. Moreover, since the amended 10b-5 complaint points to the acts of Appellees as individuals as well as conspirators, the finding of Watchie's good faith does not

preclude the finding of individual security violations on the part of Lynn and McCambridge.

Watchie was named as a defendant in both suits. Collateral estoppel will preclude relitigation of those matters or issues that were litigated and were necessary to the state court judgment.[5] A three-part test to determine the applicability of the doctrine was discussed by the Court in *Blonder-Tongue Laboratories, supra,* at 323-24. Appellants here are not collaterally estopped from bringing the 10b-5 suit unless each of the following questions is answered affirmatively: Was there a final judgment on the merits? Was the party against whom the plea is asserted a party or in privity with a party to the prior adjudication? Was the issue decided in the prior adjudication identical with the one presented in the action in question?

The first question presents little problem within the context of this case. The state court judgment was clearly a final judgment on the merits.

The second question is also to be answered affirmatively. The parties against whom collateral estoppel is asserted were parties in the state suit.[6] The state suit was filed as a class action under Washington State C.R. 23(b)(1).[7] The federal suit was filed un-

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[5] 1B Moore's Federal Practice, ¶ 0.441(2), at 3777.

[6] It is insignificant that CMA Corporation was a plaintiff in the state suit and not in the federal suit. For collateral estoppel purposes, it is important only that all the plaintiffs in the federal suit had the opportunity to litigate the state claim.

[7] Washington State C.R. 23(b)(1) is identical to Rule 23(b)(1), Federal Rules of Civil Procedure.

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der 23(b)(3) of the Federal Rules of Civil Procedure.[8] Appellants contend that the plaintiffs in the two actions are not the same because notice was not given to absent class members in the state suit and, consequently, those absent members cannot be bound by judgment. That contention is without merit.[9] In effect, plaintiffs in the two actions are the same class, namely, that class of limited partners of Cougar Mountain Associates.[10]

Determination of the third question involves inquiry into whether the factual issues in the two suits and the standards applied in each are identical. See *Peterson v. Clark Leasing Corp.*, 451 F. 2d 1291, 1292 (9th Cir. 1971).

The factual issues in the two suits are not identical. The state suit asked for a partnership accounting and damages. The state complaint alleged that Wat-

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[8] Appellants originally contended that class status could be granted in the federal suit under 23(b)(1), Federal Rules of Civil Procedure. Appellants have subsequently conceded that 23(b)(3), Federal Rules of Civil Procedure is the only appropriate class action provision for a 10b-5 suit. *Cf. LaMar v. H&B Novelty & Loan Co.*, 489 F. 2d 461, 466-467 (9th Cir. 1973).

[9] See 3B Moore's Federal Practice, ¶ 23.55 at 1152:

> "There will be situations where the class is cohesive, or where the legal relationship of the members enables one or more to stand in judgment for all and where the representatives are truly representative—a most important factor. In these * * * situations we suggest that, although some notice to the members may be desirable and may be given * * * a judgment should be res judicata to all the class, even in the absence of notice, in the (b) 1 and (b)(2) situations where the requirements of Rule 23 have been satisfied."

[10] Except of course those limited partners named as defendants in the action.

chie mismanaged the partnership from 1961 through 1967. Each allegation related to the buying, selling or appraising of real property. The answer and counterclaim were also confined to the management of the partnership. The state court held that Watchie made mistakes of judgment but that he did not breach his fiduciary duty to the partnership. The state suit, then, resolved issues of non-disclosure with respect to the operation of the partnership itself from 1961 to 1967.

The federal complaint alleges that Appellees, by concealing material facts, violated and conspired to violate Rule 10b-5 in the sale of limited partnership units in 1961 and 1962. In *Watson v. Roberts, Scott and Company, Inc.*, 466 F. 2d 1348 (9th Cir. 1972), we held that in cases in which the state court did not decide issues of fact or law that would be dispositive of a federal action, the state judgment could not collaterally estop litigation of a subsequent federal suit. Here, neither complaint nor answer referred to federal securities law. Only one finding of fact in the state judgment mentions the selling of partnership units.[11] That finding stands alone and lacks relevant substance. It is therefore unnecessary to the state judgment. See *Fibreboard Paper Products Corp. v. East Bay Union of Machinists Local No. 1304*, 344

[11] Finding of Fact No. 70 states:

"When he had engaged in selling the units of limited partnership during 1961 and 1962, defendant H. R. Watchie had represented that he had special experience * * * with respect to the buying, selling and development of raw land."

F. 2d 300, 306 (9th Cir.), cert. denied 382 U.S. 826 (1965), wherein we said that "where estoppel by judgment is asserted, the earlier determination must have been of a question of fact essential to the earlier judgment."

Not only were the factual settings in the two suits different, but different legal standards are to be applied to assess liability in each suit. We considered the legal standard applicable to a 10b-5 claim in *White v Abrams*, 495 F.2d 724, 734 (9th Cir. 1974). There we said that "we reject scienter or any other state of mind as a necessary and separate element of a 10b-5 action." Under the *Abrams* standard, liability can be based on negligence, either with respect to the facts involved or the disclosure required.

In the state suit, the Court found no breach of fiduciary duty on the part of Watchie since all his mistakes were honest. Watchie's mistakes in judgment could have been negligent but since they were honest, he was absolved of the alleged breach of fiduciary duty.[12]

The federal test, as set out by this Circuit, holds

[12] Subsequent to the state judgment, the Supreme Court of Washington posited the standard to be applied when analyzing an alleged breach of fiduciary duty. In *Bassan v. Investment Exchange Corp.*, 83 Wash. 2d 922, 524 P. 2d 233 (1974), the court apparently rejected a state of mind standard in determining whether one has breached his fiduciary duty. Thus, the Washington standard for breach of fiduciary duty is now more similar to this Circuit's 10b-5 standard. Nevertheless, when collateral estoppel is the issue, it is the standard applicable at the time of the earlier decision which is significant.

a defendant to a higher standard of accountability than the Washington standard for breach of fiduciary duty.

MAINTENANCE OF A 10b-5 SUIT AS A CLASS ACTION

Before permitting a suit filed under Rule 23(b)(3) of the Federal Rules of Civil Procedure to be maintained as a class action, the Court must find that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members. The Court must also find that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.

The district court adopted the special master's report without extensive comment. The report stated that none of the Appellees made written representations to the purchasers of limited partnership units. The master reasoned that since the alleged omissions and misrepresentations were oral, separate determinations would have to be made of what was disclosed to each limited partner. He concluded that questions of law or fact common to the members of the class do not predominate over questions affecting only individual members.

Appellants contend that we should hold that common questions predominate. They reason that it is important that the presentations of some salesmen may have differed from others only if the element of

reliance is a prerequisite to ultimate liability. In support of their contention that reliance is not an element in a 10b-5 suit, Appellants cite *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-154 (1972). There the Supreme Court said that "positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of the decision."

In so arguing, Appellants misconceive the issue. Although they might not have to establish reliance to ultimately succeed in the suit, Appellants must show, as a condition to class status, that any misrepresentations or non-disclosures were common to the class.[13] They have not done so for they have not shown that the alleged misrepresentations and non-disclosures involved every limited partner.[14]

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[13] In this connection, the Second Circuit case, *Herbst v. International Telephone and Telegraph Corp.*, 495 F. 2d 1308 (2nd Cir. 1974), is inapposite. The Court held that since individual reliance was not an element, the district court did not err in holding that common issues of law and fact were predominant. In *Herbst*, the alleged misrepresentations were issued through a written prospectus. In certifying the suit as a class action, the district judge could have assumed that all class members received the standardized prospectus. A similar assumption cannot be made in this case. Furthermore, other courts have held that oral misrepresentations lead to individual questions because they are not standardized in the same sense as misrepresentations appearing in a prospectus or financial statement. See *Moscarelli v. Stamm*, 288 F. Supp. 453, 462 (E.D. N.Y. 1968); *Simon v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 482 F. 2d 880, 882 (5th Cir. 1973).

[14] Appellants have the burden of showing that common questions predominate. Cf. *Poindexter v. Teubert*, 462 F. 2d 1096, 1097 (4th Cir. 1972).

In *Price v. Lucky Stores, Inc.*, 501 F. 2d 1177 (9th Cir. 1974), we said:

> "A class action determination under Fed. R. Civ. P. 23 is one of a trial court's considered discretion. (Citations omitted.) * * * This is so because the district court is in the best position to consider the most fair and efficient procedure for conducting any given litigation. Such a determination by the Court will not be disturbed on appeal unless the party challenging it can show an abuse of discretion." 501 F. 2d at 1179.

Other circuits have similarly deferred to the judgment of a district court in determining whether a suit should be maintained as a class action. See *City of New York v. International Pipe and Ceramics Corp.*, 410 F. 2d 295 (2nd Cir. 1968); *Wilcox v. Commerce Bank of Kansas City*, 474 F. 2d 336 (10th Cir. 1973); *Castro v. Beecher*, 459 F.2d 725 (1st Cir. 1972); *Hackett v. General Host Corp.*, 455 F. 2d 618 (3rd Cir. 1972).

If the trial judge has made findings as to the provisions of the Rule and their application to the case, his determination of class status should be considered within his discretion. *Price, supra*, at 1179; *City of New York, supra*, at 248; *Wilcox, supra*, at 345. Here, the special master analyzed the provisions of Rule 23(b)(3) and determined that the common questions of law and fact did not predominate over the individual questions. We hold that this analysis which was adopted in full by the trial court, meets the test set out in *Price, supra.*

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Accordingly, we hold that the trial court did not abuse its discretion when it made a class action determination against Appellants.

The judgment of the district court is vacated and the case is remanded for consideration consistent with this Opinion.

Text of June 5, 1975 order of the United States Court of Appeals for the Ninth Circuit denying respondents' petition for rehearing

Before: CHAMBERS and WRIGHT, Circuit Judges, and THOMPSON,* District Judge.
for the District of Nevada, Reno, Nevada, sitting by designation.

A petition for a rehearing has been filed; also bills of costs and objections thereto have been filed. Good cause appearing, IT HEREBY IS ORDERED:

1. The slip opinion dated April 2, 1975 in the action entitled above is hereby amended as follows:

(a) The second full paragraph on page 7 thereof is hereby amended to read as follows:

"The federal test, as set out by this Circuit, holds a defendant to a higher standard of accountability than that adopted by the Washington Court in the state action."

(b) Footnote 12 on page 7 of said opinion shall be stricken.

2. Pursuant to Rule 39(a), Federal Rules of Ap-

* Hon. Bruce R. Thompson, United States District Judge

pellate Procedure, both parties having prevailed in part, each party shall bear his own costs on appeal and costs on appeal are not allowed to any party.

3. The petition for a rehearing is denied.

District Court Order Denying Class Status to Suit

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

RICHARD A. CLARK, et al.,
Plaintiffs,

v.

H. R. WATCHIE, et ux, et al.,
Defendants,

GENE LYNN,
Third Party Plaintiff,

v.

ROBERT W. BRATTON, et ux, et al.,
Third Party Defendants.

CIVIL ACTION
No. 7980

FINDINGS AND ORDER CONCERNING CLASS ACTION MOTION

Plaintiffs filed a motion for determination by this court that this case be designated a class action. This

motion was heard before Special Master Kenneth S. Treadwell, to whom this motion and all other pretrial proceedings had been referred. The Special Master filed his report containing his findings of fact concerning the class action issues and concluding that the motion for a class action treatment should be denied. Plaintiffs filed objections to the report and also noted a request that the court hear certain motions to amend their complaint prior to a determination of the class action issue. The matter of the motion to amend had been previously noted before the Special Master and had been reserved for ruling after the court's determination of the class action issues and of certain motions for summary judgment which had been brought by the defendants Lynn and Gustaveson. This court has previously heard the plaintiffs' motion to allow an amendment of the complaint prior to consideration of the class action and after a review of the briefs and records concerning said motion affirmed the Special Master's ruling in that regard.

Applications for review of the Special Master's report on the class action issue were heard before the undersigned on November 11, 1971. At the hearing the plaintiffs were represented by Joseph C. McKinnon and the defendant Lynn by Payton Smith, defendants Gustaveson by Arnold J. Barer, and the 3rd party defendant Elizabeth A. Clark by William Wesselhoeft. Mr. Alec Brindle and Mr. C. M. McCune, attorneys for certain third party defendants were also present for a portion of the argument and hearings on that date.

This court has considered the briefs of counsel submitted in connection with the class action motions, the transcripts of the arguments before the Special Master regarding said issue, arguments of counsel, and the files and records submitted to date as well as the Special Master's report. Based on the above, this court makes the following findings:

A. The evidence and records fully support the findings of fact of the Special Master concerning class action treatment and his report is affirmed and adopted.

B. This court, based upon its own review of the files and records finds that class action treatment should be denied. In so denying class action treatment and making said findings, this court has considered and adopts as its own findings, the following portion of the Special Master's report:

> "This action grows out of an alleged conspiracy entered into in early 1961 between the various defendants who allegedly devised a plan to defraud investors in Cougar Mt. Associates. The scheme called for the creation of the limited partnership and the sale of limited partnership units to investors by the use of concealment, half truths and false statements, the later sale to the partnership of real estate, in which the defendants had some interest, at exorbitant prices. In order to sell the units, H. R. Watchie, conducted well over one hundred public meetings in which he made an oral presentation, later the prospects present were contacted by one of some twenty salesmen who would make a further oral sales

'pitch.' Some 400 different investors each paid or committed to pay $20,000 for a unit. Each prospect received a printed copy of the Articles of Limited Partnership but nothing more. The purchasers of the units came from every walk of life, lawyers, stockbrokers, doctors, real estate salesmen and brokers, and the statements made to each varied and the reliance placed on the sales 'pitch' by such diverse purchasers must of necessity varied.

"None of the defendants issued or published any written representations in writing. The concealment of material facts, half truths and false statements alleged by the plaintiffs were oral and the statements made or not made will vary in the case of every sale made to a limited partner. Therefore, it cannot be found that 'question of law or fact common to the members' predominates over questions affecting individual members of the class. Since a separate determination will have to be made as to each limited partner with regard to misrepresentation or failure to disclose facts, it follows that a class action in this case could very well require the trial of some 380 separate claims."

From the foregoing findings this court concludes that the class action motion should be denied and IT IS SO ORDERED.

DATED this 26th day of November, 1971.

UNITED STATES DISTRICT JUDGE

s/ *Walter T. McGovern*

Report of Special Master

IN THE DISTRICT COURT OF THE
UNITED STATES FOR THE WESTERN
DISTRICT OF WASHINGTON, AT SEATTLE

RICHARD A. CLARK, et al.,

Plaintiffs,

v.

H. R. WATCHIE, et ux, et al.,

Defendants,

GENE LYNN,

Third Party Plaintiff,

v.

ROBERT W. BRATTON, et ux, et al.,

Third Party Defendants.

CIVIL ACTION

FILE NO. 7980

REPORT OF SPECIAL MASTER
RE: SUMMARY JUDGMENT AND
CLASS ACTION ORDER

During the 1950's and early 60's the land values east of Lake Washington were increasing in value at a fairly rapid rate. H. R. Watchie operated a real estate business in that area under the name and style of Lakemont Realty Company. Later the business was incorporated and the name changed to H. R. WATCHIE and Associates, Inc.

Commencing in the middle 1950's Mr. Watchie

organized groups of individuals into syndicates for the purpose of acquiring unimproved land. The syndicate would hold land until it increased in value and then sell it. Because of the rapid increase in land values Watchie was able in many cases to sell the land at double what the syndicate paid for it. In a number of instances one of Watchie's syndicates would sell to another syndicate organized by Watchie. In early 1960 Watchie embarked upon a more expanded operation and in May of 1961 organized Cougar Mt. Associates. This was a limited partnership organized under the laws of the State of Washington and authorized to sell 600 limited partner units to the public. H. R. Watchie was the sole general partner. A limited partnership unit required an initial capital contribution of $5,000 and additional annual contributions of $1,750 not to exceed $15,000 making each limited partnership unit cost $20,000.

The purpose of this partnership was to purchase and sell real property and the articles of partnership gave Watchie very broad powers in determining the price, amount and location of the property. The articles also authorized Watchie to purchase for the partnership property in which he had an interest and further permitted him to act as agent and broker and receive commissions on such purchases and sales.[1]

Approximately 400 limited partnership units were sold to the public by Watchie and salesmen employed by him. In additional approximately 50 limited part-

[1] Sec. A 4 and 5 Articles of Limited Partnership.

nership units were transferred to H. R. Watchie for commisisons and equities owned by him in property sold to the partnership.

In marketing these units, some 100 meetings of prospective purchasers were held in the Harbor Club in Seattle or in the Blue Dolphin in Bellevue. At these meetings H. R. Watchie would make a general presentation as to the purposes and hopes of the endeavor. These meetings would be followed up by various salesmen contacting the people present in an effort to close a sale. The salesmen employed by Watchie were somewhat carefully selected to insure a group of salesmen of diverse backgrounds and interests. The sales staff consisted of former bank vice-presidents, college graduates, retired business men, mechanics, etc. so that there would be a salesman available for every type of prospective purchaser. Consequently the purchasers of partnership units covered the full spectrum of the community. Many purchasers were sophisticated land dealers and real estate salesmen, many attorneys and doctors purchased units, and many of the purchasers were former members of syndicates that sold land to the partnership.

From the time of its inception through May, 1964, Cougar Mt. and Associates acting through H. R. Watchie purchased sixty-six parcels of land in Bellevue, Lake Sammamish, Redmond area totalling 3,961 acres at a total price to the partnership of $10,015,-727.33. The partnership through June of 1966 sold

some 675 acres of land for a total sales price of $2,368,461.84.[2]

Forty-three properties or sixty-five percent of the original sixty-six properties acquired by the partnership were sold to the partnership by H. R. Watchie or one of his controlled companies with H. R. Watchie or one of his controlled companies acting as broker. These forty-three properties comprise some 2400 acres or sixty percent of the total acreage purchased. These forty-three properties were acquired between September, 1958 and July, 1961, by syndicates organized by Watchie for some $2,800,000. This same real estate was then sold to H. R. Watchie or one of his controlled companies to the Cougar Mt. Associates partnership for $5,500,000.[3] Twenty-six of the properties referred to were acquired by the partnership at exactly double the previous price paid by the seller. Of the remaining seventeen properties, nine sold for more than double the previous purchase price and eight were sold to the partnership for less than double the purchase price.

Sometime during the latter part of 1965 and early 1966 some of the limited partners became disenchanted with Watchie's operation and started to question his business judgment and some of his financial transactions. This disenchantment basically resulted from the fact that the general partner was still calling upon the limited partners for the annual assessment of

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[2] Beezer Report p. 65.
[3] Beezer Report p. 55.

$1,750 when they had been led to believe that only two and at most three assessments would have to be made.

These disenchanted limited partners held a number of informal conferences as a result of which a formal meeting was called February 16, 1966, at the Orcas Room of the Civic Center of all of the limited partners. The general partner appeared and was examined relative to the partnership operations. This meeting left many of the limited partners deeply concerned and worried about their investment and dissatisfied with the information they had received from Watchie. This group formed themselves into an informal group known as the Cougar Mt. Associates Protective Association and solicited contributions of $100 each from all limited partners. They arranged for the employment of the law firm of Schweppe, Doolittle and Krug to make a complete detailed analysis of the business Cougar Mt. Associates. This was done with the aid of a firm of CPA's and a firm of MAI appraisers. This report (known as the Beezer Report and filed as document # 216 in this proceeding) was critical of Watchie's management of the partnership affairs and of the legal opinion pointing out the following deficiencies:

1. A loan transaction involving $500,000 was usurious.

2. That H. R. Watchie, the general partner, made purchases of real property in excess of the fair market value of said property. The real property purchased by the partnership was valued by the apprais-

ers as having a total value of $7,341,500. The partnership had paid a total of $10,015,727.33 for this property.

3. The general partner as of June 30, 1966, had permitted unpaid real estate taxes to accumulate against the properties purchased in the amount of $151,995.52.

4. The Articles of partnership provided that H. R. Watchie or related persons or entities may transfer property interests to the partnership in which H. R. Watchie or related persons has an interest of more than ten percent providing the valuation of such property was substantiated by at least three appraisers' valuations. The general partner failed to obtain fully documented appraisals from the MAI appraisers required but in lieu thereof obtained letters of opinion from MAI appraisers.

The recommendation of the attorneys was that the contents of the report be brought to the attention of the general partner and the deficiencies corrected. Also suggested more control of the partnership affairs by the limited partners by use of a corporate form of business organization to serve as a general partner.

While the protective committee investigation was in progress the Securities and Exchange Commission undertook a study of the affairs of Cougar Mt. Associates. As a result of which the Securities and Exchange Commission commenced an action in the United States District Court to enjoin Watchie from making further assessments on limited partners of Cougar Mt. Associates until a full disclosure had been made to the limited partners by the general partner. Such a report was prepared by the general partner

under the supervision of the Securities and Exchange Commission and in the summer of 1967 distributed to all limited partners. That report made a full disclosure of the financial problems of Cougar Mt. and Associates.

Following the completion of the Schweppe report, Watchie consented to the creation of a corporation to be formed to take over as a general partner. This change was effected in the late summer of 1967 by the resignation of Watchie and the substitution of the corporation as general partner. Watchie and several former limited partners of Cougar Mt. Associates became directors of the new corporate general partner and Watchie was elected President. Watchie functioned in this capacity for a short time when disagreements arose between him and the other directors over the management of the affairs of the partnership. Thereafter the managing corporate partner commenced an action against Watchie to recover partnership assessments due on the approximate fifty limited partnership units owned by Watchie. This suit was settled by Watchie's surrendering for cancellation all the limited partnership units owned by him.

After the reorganization, the new corporate general partner continued to operate the business of the partnership calling on limited partners for assessments and managing the property of the partnership.

All assessments due on limited partnership units have now been made and collected except in the few cases of a few limited partners who refused to pay

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their assessments and their units have been forfeited and cancelled.

The foregoing then is a short history of the unsuccessful land speculation of Cougar Mt. Associates. Some seven years after most of the limited partners had acquired their partnership units, on Oct. 29, 1969, after years of investigation by accountants, attorneys and appraisers of the some sixty-six land transactions entered into by the partnership, a number of limited partners acting for themselves and on behalf of all other limited partners commenced this action against H. R. Watchie and H. R. Watchie and Associates, Inc. Almost a year later after many depositions and additional investigation by the attorneys for the limited partners, the action was amended to include as party defendants, the officers and directors of H. R. Watchie and Associates, Inc.

The plaintiff's theory is that the officers and directors of H. R. Watchie and Associates, Inc. conspired together to create Cougar Mt. Associates and sell to that limited partnership a number of parcels of land held by syndicates created by H. R. Watchie prior to mid-summer 1961 at inflated prices. It is alleged that this conspiracy is in violation of Sec. 15b of the Securities Exchange Act of 1934 and Security and Exchange Rule 10b-5.

The defendants, Watchie and his wholly owned corporation, H. R. Watchie and Associates, Inc., denies most of the material allegations of the complaint in their answer and counterclaim against one of the

plaintiffs, James H. Evans, for the sum of Two Million Dollars for damages to Watchie. The other corporate officers with the exception of Gene Lynn have filed answers denying the plaintiff's allegations. Gene Lynn, however, filed an answer denying allegations of the complaint and by Third Party Complaint asserts claims against two classes of limited partners. The first, some twenty-one limited partners who were members of syndicates that sold land to the partnership at a profit and second, some members of the so-called "Cougar Mt. Protective Committee" who by their actions caused the various limited partners to meet the assessments due on their partnership units for the years 1966 through 1968; these parties in effect joined in that conspiracy and therefore they are responsible along with the principal defendants for any damages, his theory being that if a conspiracy existed to defraud the limited partners, the members of the committee joined in that scheme by soliciting and urging members to pay such assessments.

STATUTE OF LIMITATIONS

Defendants, Lynn, Gustafson and McCambridge moved for summary judgment on the grounds that the claims of the plaintiffs arose more than three (3) years prior to the filing of this action.

Since the Federal Securities Acts do not contain any reference to a period of limitations, the Federal Court must refer to and apply the statute of limita-

tions of the appropriate State Court.[4]

Fratt v. *Robinson*, 203 F.2d 627 (9th Cir. 1953). Bromberg Security Law, 41, § 2.5 (1).

The applicable limitation statute of the State of Washington is found in R.C.W. 4.16.080 (4). That statute provides in part as follows:

> "Within three (3) years; . . .
>
> "(4) An action for relief upon the ground of fraud, a cause of action in such case shall not be deemed to have accrued until the discovery by the aggrieved party of the facts constituting the fraud. . . ."

There are a number of cases dealing with factual situations that will commence the running of the statute. Generally the aggrieved party must discover evidential facts sufficient to lead a reasonably prudent person to believe that he has been defrauded. Factual knowledge of the fraud will be inferred if the aggrieved party, by the exercise of due diligence could have discovered it.[5]

The defendants have filed many affidavits and extensive memorandums analyzing the facts of this complicated and involved case in an effort to show that each one of the named plaintiffs had possession of sufficient facts leading each to the belief that he had been defrauded, and that this evidence had come to the attention of each more than three years prior to the commencement of this action.

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[4] *Turner* v. *Lundquist*, 377 F.2d 44 (9th Cir. 1969).

[5] *Errion* v. *Connell*, 236 F.2d 447 (9th Cir. 1956). *Turner* v. *Lundquist*, 377 F.2d 44 (9th Cir. 1967).

The position of the defendants is not without merit, considering the fact that most of the limited partnership units had been sold to the public before the end of the year 1961, and that the plaintiff's original action was not commenced until almost seven years later in November of 1968, and the defendants, Lynn, Gustafson, and McCambridge were not made parties until July 16, 1969.

While many of the plaintiffs had early doubts and concerns about their investment and the manner in which the general partner was handling the partnership property, these concerns and doubts involved the safety of the investment and not the possibility that they had been defrauded. At the time the limited partners purchased their units they had been led to believe that their investment would double in a very short while and that only two or three annual assessments would have to be made. A depressed real estate market and high interest rates slowed up the rapidly increasing property values that had been incurring the previous decade. This concern about their investments is not factual evidence of fraud. It was not until a number of limited partners banded themselves together in the so called Cougar Mt. Protective Association and collected from limited partners $100 contributions creating a fund of well over $20,000 that any meaningful investigation could be made. With this fund, attorneys were employed, accountants and appraisers were put to work, and the so called Beezer Report was produced, at a total cost in excess of $25,000. That investigation began in May of

1966 and the results were published in February, 1967. This report indicated some possible wrongdoing by the general partner. However, it was not until further investigation had been made that it appeared that there might possibly be a violation of Rule 10b-5 in the sale of the partnership. This violation, as alleged by the plaintiff, is a conspiracy entered into by all the parties defendants sometime during the summer of 1961 and did not come to light until after the commencement of the original lawsuit and only after extensive depositions and investigation by plaintiff's attorney.

On a motion for summary judgment, in deciding whether there is an issue of material fact in this case, all doubts must be resolved against the moving party.[6] Therefore, the Special Master finds that there is an issue of material fact as to when the statute of limitations commenced to run and the resolution of that issue must await the trial.

MOTION FOR CLASS ACTION

The plaintiffs maintain that this action is a proper class action pursuant to the provisions of Fed. R. Civ. P. 23(b)(1)(B) or in the alternative under subsection (b)(3).

The class action is a device particularly suitable in private actions to enforce rights created by the securities laws. To this end the provisions of Rule 23, Fed.

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[6] *Cox* v. *American Fidelity & Casualty Co.*, 249 F.2d 616 (C.A. 9, 1957).

R. Civ. P. must be literally construed with a view of enhancing the use of class actions as a means vindicating the rights of all members of a class.[7] One court has said, "error should be in favor of maintaining class actions."[8] The reasons for this attitude are:

(1) Class actions are designed to conserve judicial resources by avoiding a multiplicity of suits on the same issue.

(2) Class actions are a means of compensating many investors with small claims, and

(3) The class action is a means of deterring securities frauds.

The applicable provisions of Rule 23, Fed. R. Civ. P. are as follows:

> "(a) Prerequisites to a Class Action. One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.
>
> (b) Class Actions Maintainable. An action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition:
>
> (1) the prosecution of separate actions

[7] *Berland* v. *Mack*, 48 F.R.D. 121, 125 (S.D. N.Y. 1969).
[8] *Esplin* v. *Hirshi*, 402 F2d 94, 101 (C.A. 1, 1968).

by or against individual members of the class would create a risk of

* * * * *

(B) adjudications with respect to individual members of the class which would as a practical matter be dispositive of the interest of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests; or

* * * * *

(3) the court finds that the questions of law or fact common to the members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy. The matters pertinent to the findings include: (A) the interest of members of the class in individually controlling the prosecution or defense of separate actions; (b) the extent and nature of any litigation concerning the controversy already commenced by or against members of the class; (c) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; (d) the difficulties likely to be encountered in the management of a class action."

To qualify as a class action a case must meet the first four technical requirements set forth in subsection (a) and in addition the actions must be main-

tainable under one or more of the alternative conditions specified in subsection (b).

The plaintiffs maintain the facts of this case are such that all of the prerequisites of subsection (a) are present and that this action is maintainable under two of the conditions specified by subsection (b).

The specific requirements of subsection (a) are:

First "the class is so numerous that joinder of all members is impracticable—the class in this cause consists of approximately 380 limited partners so it is clearly not practical to join them all."

Second "there are questions of law and common to the class"—since each member of the class is a purchaser of a limited partnership unit there are a number of common questions of law and fact but whether these common questions predominate over questions affecting only individual members is a serious issue.

Third "the claims or defenses of the representative parties are typical of the claims and defenses of the class"—each plaintiff is an owner of one or more limited partnership units and their claims for recovery must be founded upon the same theory as all members of the class and to that extent are "typical."

Fourth "the representative parties will fairly and adequately protect the interests of the class"—the plaintiffs have a very substantial stake in the outcome of this litigation. One plaintiff, Evans, has an $80,000 investment and the aggregate investment of all name plaintiffs exceeds $240,000. This fact alone seems suf-

ficient to guarantee adequate representation by these plaintiffs of all members of the class.

Assuming that this action meets all the requirements of Rule 23(a) before it can be continued as a class action one of the prerequisites of subsection (b) must be met. The plaintiffs first contend that this action falls within the provision of Rule 23(b)(1)(B). This subsection permits class actions if the prosecution of separate actions would "as a practical matter be dispositive of the interest of the other members not parties to the adjudications or substantially impair or impede their ability to protect their interests." The plaintiffs' reason that a successful suit by them would exhaust all the assets of the defendants leaving nothing available for other members of the class thus disposing of the interest of all absent class members. Although the Advisory Committee note to Rule 23 (39 F.R.D. 98) refers to situations where a judgment in favor of one or more members of a class will have an adverse effect on other class members claiming the same fund, the "fund" the committee was referring to does not include the aggregate assets of the defendants but rather claims against a specific trust fund, insurance proceeds of a recovered fraudulent conveyance.[9] Therefore, if this action is to proceed as a class action it can only do so if there is a finding that "questions of law or fact common to the members of the class predominate over any questions affecting only individual members."

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[9] 3B Moore's Federal Practice 23.35(2).

This action grows out of an alleged conspiracy entered into in early 1961 between the various defendants who allegedly devised a plan to defraud investors in Cougar Mt. Associates. The scheme called for the creation of the limited partnership and the sale of limited partnership units to investors by the use of concealment, half truths and false statements, the later sale to the partnership of real estate, in which the defendants had some interest, at exorbitant prices. In order to sell the units, H. R. Watchie, conducted well over one hundred public meetings in which he made an oral presentation, later the prospects present were contacted by one of some twenty salesmen who would make a further oral sales "pitch." Some 400 different investors each paid or committed to pay $20,000 for a unit. Each prospect received a printed copy of the Articles of Limited Partnership but nothing more. The purchasers of the units came from every walk of life, lawyers, stockbrokers, doctors, real estate salesmen and brokers, and the statements made to each varied and the reliance placed on the sales "pitch" by such diverse purchase must of necessity varied.

None of the defendants issued or published any written representations in writing. The concealment of material facts, half truths and false statements alleged by the plaintiffs were oral and the statements made or not made will vary in the case of every sale made to a limited partner. Therefore, it cannot be found that "question of law or fact common to the members" predomniates over questions affecting indi-

vidual members of the class.[10] Since a separate determination will have to be made as to each limited partner with regard to misrepresentation or failure to disclose facts, it follows that a class action in this case could very well require the trial of some 380 separate claims.

Even if this action could have, at its inception, qualified as a proper class action, that status was changed when additional defendant, Lynn, brought in some forty Third Party Defendants on the theory that they had either profited by the defendants fraud or joined in the conspiracy. The third party complaints will require a separate hearing as to each.

If some of the class members profited from the defendants fraud or joined in the conspiracy, the defendants will be entitled to raise the issue of pari delicto against such members further complicating the trial.[11]

Therefore, to permit this litigation to continue as a class action will place a gigantic burden on the court's resources far beyond its capacity to manage or effecitvely control.

The Special Master finds that this case does not qualify as a class action either under F. R. Civ. P. 23 (b) (1) (B) or 23 (b) (3).

The prevailing party on each motion will prepare

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[10] *Morris* v. *Burchard*, 4 C.C.H. Federal Securities Law Reporter § 92, 910 (S.D. N.Y. 1971). *Moscarelli* v. *Stamm*, 288 F. Supp. 453 (E.D. N.Y. 1968).

[11] "The Impact of Class Actions on Rule 10b-5," University of Chicago Law Review, 337 at 356.

and present appropriate orders in conformity with these findings at the time of hearing before the District Judge.

Dated this 7th day of October, 1971.

Respectfully submitted,

Kenneth S. Treadwell
Referee-Special Master

Portion of Plaintiffs' Preliminary Pretrial Statement Entitled "What Plaintiffs Expect to Prove," R. 165-176

During the years 1958 and 1959 and 1960 and the first few months of the year 1961, defendant H. R. Watchie and Associates, Inc. (then known as Lakemont Realty, Inc.) was a real estate brokerage organization engaged in an unorthodox type of raw land real estate business. Most of its activities related to the sale of property interests that more nearly resembled investment contracts than conventional interests in real estate.

A few of the firm's customers were relatively sophisticated real estate investors. They participated in land syndicate sales arranged by H. R. Watchie and Associates, Inc. after having examined the properties and arrived at some independent conclusion as to value and likelihood of appreciation.

Most of the customers knew little or nothing about land values. Typically, they did not even look at land in which their money would be invested. They merely advanced sums of money to H. R. Watchie and Associates, Inc. with the understanding that the funds of several customers would be pooled and invested in land that was likely to double in value in three years or less. Selection of the land, and determination as to the price to be paid for it, was left to the corporation. It also selected the investors who would make up a

given syndicate and selected a trustee to purchase the land in his own name for the benefit of the syndicate members.

Each member became obligated to pay his proportionate share of real estate taxes and of installment payments on the tract of land purchased by the syndicate in which he participated. Aside from providing his share of the initial investment and of such annual payments as proved to be required before the land was resold, the investor had nothing to do with the property. He frequently would have only a general idea of its location and would have no first hand information whatsoever as to its value.

The syndicate members ordinarily signed an agreement that the trustee selected by H. R. Watchie and Associates Inc., could resell the property at any time when a purchaser could be found who would pay twice the price that the syndicate had agreed to pay to its vendor. H. R. Watchie and Associates salesmen and investors referred to such resales as "doubles."

The corporation obtained doubles for many of its investors. Those customers did considerably better than merely doubling their money. A typical syndicate purchase was on installment real estate contract with 20% down and the balance to be amortized over a ten to fifteen year period. If a syndicate's tract of land could be resold at a double in a year or two, syndicate members received a paper profit of several hundred percent after paying H. R. Watchie and Associates, Inc. a ten percent commission on the resale.

Most of the doubles resulted from sales by one H. R. Watchie and Associates, Inc. syndicate to another. On most such occasions no member of either syndicate had independent knowledge as to the value of the tract of land being purchased and sold. All of the investors relied upon the corporation to fix the price to be paid by the purchasing syndicate.

The price so fixed frequently gave the sellers a double. The resulting word of mouth advertising brought new investors to H. R. Watchie and Associates, Inc. The availability of new investors provided a market for land that was sold at prices fixed by H. R. Watchie and Associates, Inc., rather than by negotiation of buyer and seller in the light of the factors usually considered in fixing selling prices of similar parcels of raw land.

The corporation thereby created and maintained an artificial market with unrealistically high prices for raw land. Although the syndicate transactions were conducted in that artificial market, they did have some affect on the real market. Each of the H. R. Watchie and Associates, Inc. syndicate transactions became a matter of public record. Some buyers and sellers who were unaware of the inbred nature of the transactions arranged by H. R. Watchie and Associates, Inc. tended to consider such sales to be arms length transactions which could serve as a measuring stick for determining the value of comparable parcels of land. During 1959 through 1962 most raw land sales in a considertable area of land east of Lake

Washington were made through that corporation.

Yet there was a limiting factor which made it impossible for H. R. Watchie and Associates, Inc. to continue indefinitely with a practice of doubling prices of the tracts in short periods of time. In the long run the highest prices that could be justified for such tracts were the prices which land developers and mass builders would pay for the land in order to put it to use, as distinguished from acquiring it merely for purpose of specualtion.

Most of the parcels sold by H. R. Watchie and Associates syndicate were sold at prices considerably higher than those which developers and builders were willing to pay. Such land was actually appreciating in value at a rate approaching twenty percent per year. Unfortunately, it did not double and redouble in the short periods of time that the syndicates held the parcels before reselling them.

Although it appeared that H. R. Watchie and Associates, Inc. was creating a bubble which was likely to burst, it was receiving very large real estate commissions from its syndicate sales. Many of the commisisons are shown on Schedule E of the June 15, 1967 report of Cougar Mountain Associates. Sometimes two or even three commissions were received on sales and resale of the same property in a period of less than four years. In at least one instance there were four commissions on one property in about three years.

Those commissions were received on the tract

shown as Cougar Mountain Associates' property No. 32, on that Schedule E. As is there shown, a Mr. Baird, who was one of Mr. Watchie's associates, and a corporation that was owned by Mr. Watchie, acquired the property from a stranger for $15,000 on October 9, 1958. A $1,500 commisison was paid by the seller. On the same day, the property was resold to a group of H. R. Watchie and Associates, Inc. investors for $25,000. H. R. Watchie and Associates, Inc. received $1,250 as a second commission on the same land. The first group of H. R. Watchie and Associates, Inc. investors resold the property to another such group on November 15, 1959 for $45,000. $4,500 was paid to H. R. Watchie and Associates, Inc. as its third commisison on sales of this tract. The last syndicate resold to Cougar Mountain Associates on January 8, 1962 for $90,000. The last sellers paid H. R. Watchie and Associates, Inc. a commisison of $9,000. In 39 months the price of the property had advanced from $15,000 to $90,000. In the same period of time H. R. Watchie and Associates, Inc. had received commissions on four sales of this same property in a total amount which exceeded the original selling price of the land.

In 1961 defendants H. R. Watchie, Gene Lynn, E. Joseph McCambridge and James Gustavson controlled H. R. Watchie and Associates, Inc. Mr. Watchie was president of the corporation and owned its stock. Mr. Lynn was executive vice president and chief assistant to Mr. Watchie. Mr. McCambridge was vice president and sales manager. Mr. Gustaveson

had no office in the corporation but was a close associate of the other defendants and participated with them in the management of the corporation.

Early in 1961 the defendants devised a plan which was calculated both to prevent the bubble from bursting and to obtain large amounts of money for the defendants. The plan was to create Cougar Mountain Associates and cause it to pay high prices for most of the properties being purchased by the H. R. Watchie and Associates, Inc. syndicates as well as for a considerable amount of property in which the defendants had interests.

The plan had obvious advantages for the defendants. The syndicate investors were to be given an opportunity to resell their properties at high prices so that the syndicate members would have no claims against the defendants. The sales would produce about one million dollars of commissions for H. R. Watchie and Associates, Inc. That would enable it to pay large dividends to Mr. Watchie; to pay an extremely high salary and generous commissions to Mr. Lynn, and to pay large commissions to Mr. McCambridge and Mr. Gustaveson. Further, each of the defendants would benefit by sales, at high prices, of properties in which he and related persons and entities had interests.

The greatest advantage was that the plan, if successful, would give the defendants a chance to gain the time that was essential in order to prevent their land sales bubble from bursting. If business had con-

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tinued to go on as before, there would soon have come a time when it was no longer feasible to continue giving some groups of syndicates doubles at the expense of other syndicates. There necessarily had to be some limit to the extent that the prices charged on the H. R. Watchie and Associates, Inc. private market exceeded true market prices. Yet, if syndicates were not continued to be given opportunities to resell at high profits, the members might become disgruntled and investigate their purchases. Such investigations were likely to disclose that the prices paid by the syndicates were far in excess of true market values.

Investigation of the market value of a single property is neither costly nor difficult. Accordingly, it was reasonable to fear that failure to arrange profitable resales for the syndicates would result in several such investigations. Each was likely to trigger others and ultimately result in disaster for the defendants. Something had to be done. The partnership seemed to be the answer.

Putting substantially all of the syndicated properties into a gigantic limited partnership that would own dozens of parcels of raw land costing many millions of dollars would minimize, and almost eliminate, any danger of an investigation of the fair market values of properties acquired with funds of persons who invested through H. R. Watchie and Associates, Inc. No single investor could afford the great expense of such an investigation. The likelihood that several hundred partners could somehow manage to band

together adn share the expense of a costly investigation must have appeared to be remote.

The evidence will justify an inference that defendants believed that the partnership could purchase and hold the syndicates' properties for a few years until general appreciation in raw land values in areas east of Lake Washington caused the properties to become worth as much as the partnership had paid for them.

Another advantage to defendants was that H. R. Watchie as general partner would have complete control of the partnership. The partnership would not buy any property unless his corporation received a ten percent commission or a 1/9 markup, in lieu thereof, on every acquisition. Cougar Mountain Associates was not intended to sell property unless H. R. Watchie and Associates, Inc. received a commission on the sale. Further, H. R. Watchie and Associates, Inc. would be able to provide management services to the partnership at a price to be fixed by the corporation rather than at a price reached in competition with other corporations providing similar services. All of this would make it possible for the individual defendants to continue to obtain large dividends, salaries and commissions from H. R. Watchie and Associates, Inc.

In the spring of the year 1961, while the defendants were planning the creation of Cougar Mountain Associates, they prepared a list of properties which it would acquire. The list showed the prices which it would pay for each of them. Most of the properties

being purchased by the various H. R. Watchie and Associates, Inc. syndicates were put on the list. The syndicate members were not consulted about the prices listed for their properties. A number of tracts of land in which Mr. Watchie and his related persons and entities had substantial interests were also included on the list. Another parcel shown on the list was one in which Mr. Lynn had a substantial interest so that he stood to make a large profit if it was sold to the new limited partnership. The list also included a property which Mr. McCambridge would participate in selling to the partnership at a large profit and a parcel on which defendant Gustaveson would benefit handsomely if the indicated sale to the new partnership were to be completed.

Unlawful Sales of the Securities

The plan was carried into effect. Defendants caused Cougar Mountain Associates to be formed. Defendant H. R. Watchie and Associates, Inc.; acting under the direction and control of Messrs. Watchie, Lynn, McCambridge and Gustaveson; was the exclusive sales agency for the sale of the limited partnership units to members of the public. Those individual defendants personally participated in the sale of the units as well as directing the sales activities of defendant H. R. Watchie and Associates, Inc.

When they planned and created Cougar Mountain Associates, the defendants were well aware that its limited partnership units could only be sold by con-

cealment of material facts and use of false statements and half truths. Defendants planned to use concealment, half truths and false statements in the sale of the units. The defendants also planned that the United States mails and the facilities of interstate commerce would be used in the sale of the units.

When the units were sold, the mails and facilities of interstate commerce were used; material facts were concealed from purchasers and prospective purchasers of the units; half truths were told to them and misstatements were made to them.

Concealment of Material Facts

The things concealed from purchasers and prospective purchasers of the limited partnership units included the following material facts:

1. Defendants had created and were maintaining an artificial market in raw land in an area east of Lake Washington.

2. There was danger that persons who had purchased properties at excessive prices in this artificial market would learn that they had been misled with respect to the value of their properties and would commence appropriate legal proceedings against the defendants.

3. One of the primary reasons for the formation of Cougar Mountain Associates was to protect against the risk of such lawsuits.

4. Mr. Watchie, the sole general partner of Cougar Mountain Associates, had a fiduciary relationship to most of the persons from whom he

would cause the partnership to purchase real estate.

5. Mr. Watchie would not, and did not, attempt to negotiate the best possible prices or terms for the partnership on its transactions with persons with whom he had a fiduciary relationship.

6. Cougar Mountain Associates would, and did, pay more than the lowest prices which the sellers would accept in its purchases of most of the properties which it acquired.

7. The partnership agreement provided that if $750,000 in initial capital contribution were not obtained by August 25, 1961, all contributions would be returned and the partnership terminated. That amount was not obtained before that date but the partnership was not terminated and this failure to comply with the partnership agreement terms was concealed from the purchasers and prospective purchasers of the limited partnership units.

8. H. R. Watchie would, and did, do things which were such as to justify a conclusion that he lacked the integrity and good judgment essential for the sole general partner of a multi-million dollar partnership where the partnership agreement gave the general partner permission for extensive self-dealing. Such things include:

a. Committing the partnership to purchase properties in which he had a personal interest, without first obtaining the appraisals required by the partnership agreement.

b. Causing the partnership to purchase those properties before there had been such appraisals.

c. Arranging to receive informal appraisal opinion letters rather than the full scale MAI appraisals required by the partnership agreement.

d. Causing those limited appraisals to be deferred until general economic conditions had caused the value of the parcels of land to increase.

e. Giving the appraisers unjustified instructions and inaccurate information with a view to causing the appraisal letters to show valuations in excess of true market values.

f. Causing the partnership to pay even more than those estimated values for certain properties in which Mr. Watchie and his related persons and entities had substantial interests.

g. Causing the partnership to purchase properties in which Mr. Lynn, Mr. McCambridge and Mr. Gustaveson had substantial interests without either MAI appraisals or any attempt to negotiate the best possible price of such properties for the partnership.

h. Causing the partnership to buy a large tract of land, at a high price, for the benefit of a different partnership.

i. Causing large commissions to be paid to H. R. Watchie and Associates, Inc. at the

expense of Cougar Mountain Associates under circumstances where such commissions were not properly payable under the terms of the partnership agreement.

j. Causing two of the largest property purchases of Cougar Mountain Associates to be at prices which included prepaid interest for five years in order to increase the amount of commissions that would be paid to H. R. Watchie and Associates, Inc.

k. Taking and causing H. R. Watchie and Associates, Inc. to take 1/9 markups on property sold to the partnership under circumstances where such markups were not authorized by the partnership agreement.

l. Causing documents running in favor of the partnership to be destroyed and replaced by papers running to him or to H. R. Watchie and Associates, Inc. in order to make it appear that a 1/9 markup was authorized by the partnership agreement with respect to certain transactions.

m. Causing Cougar Mountain Associates to purchase services from corporations controlled by him without competitive bidding or any other objective method of determining that the amount paid to such corporation was fairly earned by them.

Half Truths

The defendants used and caused the using of half truths in the sale of limited partnership units. Such

half truths included the following material matters:

1. Members of the class were told that participation in low down payment raw land investments could result in very high profits. The investors should also have been advised that because of the way Cougar Mountain Associates was formed and operated there was little likelihood of profit and high risk of loss for its limited partners.

2. The investors and prospective investors in the limited partnership units were advised that the partnership would own a large amount of view property. That was true. The investors should also have been advised that because of the remote location of many such view properties, the high cost of development of some of them and the high percentages of unusable land in some of them, most of those view properties were not considered desirable by mass builders and land subdividers.

3. Prospective purchasers of the limited partnership units were advised that the defendants had made it possible for earlier investors to obtain large profits on land which was resold for them in a very short period of time. The investors should also have been advised of the circumstances of the artificial market in which those profits were realized.

4. The investors and prospective investors were advised that prices to be paid to Mr. Watchie and his related persons and entities for any property that they sold to the partnership would be justified by two of three M.A.I. appraisals. That statement should have been qualified by

disclosure of the facts shown above with respect to the purchases of property by Cougar Mountain Associates from Mr. Watchie and his related persons and entities and the facts shown above with respect to the appraisals of such property.

5. Defendants represented that the cost of sale of the limited partnership units would be 2%, or $400, per unit. That representation should have been qualified by disclosure of the fact that H. R. Watchie and Associates, Inc. would pay sales commissions of 5% on the sale of the limited partnership units although only 2% was paid to the corporation by the partnership.

False Statements

The following false statements were made to purchasers and prospective purchasers of the limited partnershilp units:

1. Defendants sincerely believed that there would be no necessity for the partnership to collect more than two or three annual installments upon the limited partnership units from the limited partners, because the partnership would be financially self-sufficient in two or three years.

2. The partnership would buy its land at wholesale prices.

3. No property would be purchased from H. R. Watchie or his related persons or entities until three M.A.I. appraisals had been made on each such property and the prices to be paid for such properties would be not more than the value of the property as shown by at least two of the three appraisals.

4. Investment in limited partnership units of Cougar Mountain Associates did not involve any risk of loss since even in the even of a major economic depression the annual assessments would be sufficient to pay for all of the properties which the partnership would be buying. The land then could be held until conditions returned to normal.

5. An investor in the limited partnership units could reasonably expect to receive a return several times greater than the amount of his investment.

6. Cash flow projections for the partnership indicated that there was little possibility of a need for payment of more than three annual installments of $1,750 in addition to the down payment of $5,000 for each limited partnership unit.

7. The limited partnership units were such attractive investments that the total expense of selling the units would be only 2%, or $400, per unit.

Plaintiffs' Disputed Contentions In Pretrial Order R. 984-994

(a) During 1961 and 1962, defendant H. R. Watchie considered Lakemont Realty, Inc., to be a team, not a one-man organization. Gene Lynn headed the land development section of this team, while E. Joseph McCambridge was in charge of sales.

(b) At all times during 1961 and 1962, defendant McCambridge was both a *de facto* and a *de jure* vice president of Lakemont Realty, Inc., in charge of sales.

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At all such times, defendant Lynn was a *de facto* vice president of the corporation, in charge of development activities, but it may be that he never became a *de jure* vice president until some time in 1962.

(c) The minute book of H. R. Watchie & Associates, Inc., does not show defendant Lynn as a vice president until the year 1962. The minute book was kept on a rather casual basis and does not necessarily reflect the true state of affairs of the corporation at any given time.

(d) Defendants Watchie and McCambridge were directors of the corporation at all times during 1961 and 1962, but effective control of the corporation did not lie with the directors. It rested with defendants H. R. Watchie, Gene Lynn, and E. Joseph McCambridge under an informal arrangement where H. R. Watchie, the controlling stockholder, looked upon E. Joseph McCambridge, Gene Lynn, and himself as a sort of informal executive committee, providing the top management of Lakemont Realty, Inc. While defendant Watchie at all times had power to overrule the opinions of defendants Lynn and McCambridge and power to ignore their suggestions, he, as a practical matter, did not overrule their decisions in their respective areas of authority. He considered all of their suggestions and usually accepted and acted upon their recommendations.

(e) While defendant McCambridge was in charge of sales activities and reported directly to defendant Watchie on sales matters and defendant Lynn was

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similarly in charge of land development matters and reported directly to defendant Watchie on such matters, all defendants officed together in a small office in Redmond, Washington. They continually discussed matters of corporate business and activities on an informal basis. All of them participated in discussions of sales matters and discussions of land development matters, as well as any other matters of importance affecting the corporation and its activities. Each was aware, at least in a general way, of what the other was doing at any given time with respect to the business of Lakemont Realty, Inc. — H. R. Watchie & Associates, Inc.

(f) Defendant Lynn always showed interest in all aspects of the business of the corporation and kept himself informed of even small details of all corporate activities, not just those of his land development department. He was a forceful and capable executive, and by the time the sale of Cougar Mountain Associates limited partnership units to the members of the public had begun, Mr. Watchie had developed a great confidence in defendant Lynn. He had, as a practical matter, become the chief assistant to defendant Watchie, although not given any such official title.

(g) During 1960 and 1961, defendants considered property owned by H. R. Watchie and by his related persons and entities and by individuals and syndicates considered to be Lakemont Realty, Inc. investors, to constitute, in a loose sort of way, an inventory of that corporation. During the winter of 1960-1961, all defendants frequently discussed the formation of one

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large syndicate which could warehouse the greater part of that inventory, and the prospective sale of its securities.

(h) Plaintiffs cannot give the date of any such discussion or the names of the individual defendants who participated in each such discussion or the precise subject of any single such discussion on any specific date.

(i) The subjects discussed included the advisability of forming such a large entity and causing it to warehouse the "inventory" of Lakemont Realty, Inc., the prices to be charged for the property which would be put into this new entity, the form of the new entity and of its securities, the amounts to be charged for each unit of its securities and the installment payments on such total charge, the reasonableness of the prices to be paid H. R. Watchie and related persons and entities for property which he and they would put into the new entity, the methods to be used in selling the securities of the new entity, the likelihood of a successful sale of such securities, the approximate amount each of the defendants expected to produce for the new entity from sales of its securities which each of the defendants expected to be able to make, the requirement that each of the defendants have a securities license in order to participate in the sale of the units, the commissions which would have to be paid in the sale of the units, the cost of selling the securities, and the income which could be anticipated by Lakemont Realty, Inc. from commissions on properties sold to the new entity.

(j) During 1958, 1959, and 1960, Lakemont Realty, Inc., had established a reputation for obtaining "doubles" for its customers. They would buy, or participate in small syndicates which would buy, tracts of land recommended by the corporation which would then be resold to a customer produced by the corporation. The resale price would ordinarily be exactly double the original purchase price. Most of the persons participating in such transactions had little knowledge of raw land real estate values and relied upon Lakemont Realty, Inc., and its personnel for advice as to what to pay and advice as to when to sell and on what terms. In many cases, the persons participating in small syndicates which entered into such transactions never inspected the land which their syndicate purchased and then resold.

(k) By the end of 1960, Lakemont Realty had created an artificial raw land real estate market where customers of the corporation were engaging in transactions between themselves at prices recommended by the corporation which were substantially in excess of the prices which land developers and mass builders would pay to purchase the land for actual use, rather than for speculation.

(l) By the beginning of the year 1961, defendants had reason to hope that in two or three more years the land purchased by Lakemont Realty, Inc., customers would become worth what they were paying for it.

(m) The formation of Cougar Mountain Associ-

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ates was planned by H. R. Watchie, E. J. McCambridge, and Gene Lynn.

(n) One purpose of the plan to form Cougar Mountain Associates was to permit warehousing of properties purchased by Lakemont Realty, Inc., customers until prices rose enough to make it possible to sell the land to strangers at prices which equaled or exceeded the amounts which had been paid for the properties by those customers.

(o) It was part of the plan that Cougar Mountain Associates would buy most of the properties held by Lakemont Realty, Inc., customers and that the partnership would pay prices which would give most such customers "doubles."

(p) The list of properties prepared by H. R. Watchie which showed properties which were intended to be put into the new partnership and the prices that would be paid for each of them was available to defendants McCambridge and Lynn during all of the time while its units were being sold.

(q) Most of the properties on which Lakemont Realty, Inc., received two or more successive commissions (one on the sale to the person or group who later sold the property to Cougar Mountain Associates and the second or third commission being on the sale to that partnership, all as shown on Schedule E to the June 1967 report of Cougar Mountain Associates) were included on that list at the prices Cougar Mountain Associates was later caused to pay for them.

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(r) Schedule E of the June 15, 1967, report of Cougar Mountain Associates is a correct tabulation of the facts purported to be summarized in that schedule.

(s) The copy of the June 1967 Cougar Mountain Associates report heretofore filed in this action is a true copy of it.

(t) It was part of the plan for Cougar Mountain Associates that it would buy tracts of land on real estate contracts and that the total price for land purchased would be equal to $20,000 for every limited partnership unit sold. Money for interest payments on real estate contracts, real estate taxes, developments costs, legal and accounting services, management expenses, and the like would come from sales of Cougar Mountain Associates real estate or from borrowing.

(u) In planning Cougar Mountain Associates and the sale of its limited partnership units, the defendants were aware of the facts set out below and agreed among themselves that it would not be necessary to disclose those facts to prospective limited partners, and those facts were not disclosed to such persons when the units were sold:

(i) There was a list of the prices that the partnership would pay for the properties that it would purchase.

(ii) Many Lakemont Realty investors who had purchased land through the corporation a short time earlier would receive double their pur-

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chase prices on resales of the land to the partnership.

(iii) The purchase price to Cougar Mountain Associates of most of the properties which it would buy would not be fixed, either by arm's-length bargaining or by appraisal, but would instead be fixed by H. R. Watchie, who would be the sole general partner of the purchaser and, at the same time, be either the seller, one of the sellers, or a fiduciary advising the seller as to the price which should be charged and accepted.

(iv) The prices which the partnership would pay for land would frequently exceed market value.

(v) No cash-flow projection of the partnership's cash needs and had been or would be prepared before the units were offered and sold to the public.

(vi) Unless land values continued to rise rapidly and resulted in profitable sales of substantial amounts of partnership land, Cougar Mountain Associates would be required to borrow money for its expenses.

(vii) Such borrowing would be costly and would require a pledge of all or substantially all of the partnership assets, because the partnership would not be in a position to provide the kind of collateral required by most institutional lenders.

(v) It was the plan of the defendants to use conventional business methods in the sale of the units, including conventional correspondence sent by mail,

ordinary use of local and long-distance telephone facilities, and travel by W. R. Watchie and others from Oregon and California to the State of Washington, all in connection with the sale of the units, and the mails and facilities of interstate commerce were used in and in connection with the sale of the units.

(w) In selling the units to the members of the public, the defendants falsely represented: that the partnership would buy land at wholesale prices; that no property would be purchased by the partnership if H. R. Watchie or his related persons or entities had a 10% or greater interest as seller of the property, unless there were three M.A.I. appraisals of it and the price to be paid by the partnership would not exceed the amount of the lowest of the two high appraisals; and that it was their state of mind that not more than two or three annual assessments were likely to be required.

(x) If defendants' representations as to their belief that there would be no need for more than two or three annual assessments upon the limited partners was not an outright falsehood with respect to the state of mind of one or more defendants, it, in that event, was at least a statement made with reckless disregard for facts known to all of the defendants and was a half-truth, in that defendants failed to disclose that there was no cash-flow projection on which that opinion could properly be based and failed to disclose the extent of the cash-flow obligations which the partnership would have.

(y) All defendants represented to prospective purchasers that investment in Cougar Mountain Associates units was likely to result in a return many times greater than the amount invested and it did not qualify the representation by showing that there were many facts which were such as to cast doubt upon the accuracy of that forecast and which were such as to give a reasonable investor reason for concern that the investment was likely to result in a loss rather than in a profit. Things that should have been disclosed with respect to that representation included:

(i) The partnership would pay too much for most of the properties which it would purchase.

(ii) The partnership would buy properties without negotiation for the lowest price which could be obtained by hard, fair bargaining.

(iii) No cash-flow projections had been prepared for the partnership.

(iv) The amounts available from the annual assessments were not large enough to pay interest and amortization on real estate purchase contracts, real estate taxes, management expense, and development costs.

(v) There was likely to be a delay of years before the properties being purchased by the partnership from the "inventory" of Lakemont Realty, Inc., would appreciate in value to the point where they could be sold at a profit.

(vi) It probably would be necessary to borrow money with raw land as security and that such loans must be expected to carry high interest rates and to involve unwelcome and dangerous forfeiture provisions.

(vii) Although a large percentage of the money to be invested in the partnership would be expended upon development of CMA No. 3 as a commercial property, the development experience of the defendants had primarily been with residential land and not with commercial property.

(viii) No soil tests had been made on tracts of land the partnership was buying, although such soil tests were necessary for many of the tracts in order to estimate the cost of development of them and to determine the suitability of the tracts for their intended uses.

(ix) No percolation tests had been made on many tracts intended to be developed by the partnership into residential lots in areas where no sewers existed.

(x) No slope analysis had been made of large, steep tracts of land acquired and to be acquired by the partnership.

(xi) Some CMA parcels contained mine caverns and mine shafts of undetermined extent with an unknown number of unfenced and unmarked entraces and air vents, so that it was not known how much, if any, of this property could be sold for residential construction without disclosure to prospective purchasers of the facts relating to such mine caverns and mine shafts.

(xii) Most of CMA No. 12 and all of CMA No. 15 and CMA No. 25 were zoned SE 35,000 square feet minimum as a matter of zoning board policy so that there was little likelihood of less adverse zoning in the future.

(xiii) Parts of CMA No. 12, CMA No. 15,

CMA No. 22, CMA No. 25, and most of CMA No. 57 had high elevations and steep access so that they would have a greater snow problem on roads than then existed in Somerset, and that problem had caused loss of sales in that subdivision.

(xiv) Development costs of Somerset had been far in excess of estimates because of shale rock formations near the surface, and there was reason to fear similar conditions on the adjacent Farmer property (CMA No. 57), but no tests were made to determine if such a shale rock condition existed on CMA No. 57.

(xv) The development manager of Lakemont Realty, Inc. had not inspected the properties being acquired by Cougar Mountain Associates for development to determine if such properties were suitable for the intended development of them and to determine the cost of such development.

(z) With regard to the sales representation that view property commanded premium prices, the defendants did not qualify that representation by disclosing the fact that most mass builders and land developers were reluctant to develop view property until the area where it was located had been built up and improved with amenities such as stores, schools, churches, and the like.

(aa) Prospective purchasers of the units were advised by defendants that the land to be purchased by Cougar Mountain Associates would be selected by experts, with the result that it would appreciate in value more rapidly than other land in the same general geographic area which an unsophisticated ob-

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server might consider comparable. The defendants did not qualify that representation by showing that much of the land was selected primarily because of a desire to give a sale at a good price to its owner, rather than because of business advantage to Cougar Mountain Associates or by disclosing that Lakemont Realty, Inc. — H. R. Watchie & Associates, Inc.'s expert on land development had not evaluated such properties to determine their suitability for their intended use and to determine the cost of developing the properties for their intended use.

(bb) Each of the defendants intended to and did profit substantially from formation of Cougar Mountain Associates and from the sale of its units to plaintiffs and to other members of the public. It was planned that either H. R. Watchie or Lakemont Realty, Inc., would receive a 10% commission or a one-ninth markup in lieu thereof on every property acquired by the corporation. That occurred. Gene Lynn's position in Lakemont Realty, Inc., became more important, and his salary increased to $50,000 per year. He received commissions in excess of $9,000 on his own sales of CMA units. E. Joseph McCambridge obtained large commissions from the sale of the partnership units. Defendants were able to provide large profits for persons who had dealt with Lakemont Realty, Inc., in the purchase of interests in raw land and thereby eliminate certain dangers. Defendants each profited from sales of land to Cougar Mountain Associates at large markups.

(cc) Cougar Mountain Associates limited part-

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nership units have a present value of approximately $5,000. The shares of stock which have been issued in lieu of one unit have an equivalent value. No interest or dividends has been paid upon the units or the shares.

(dd) Pursuant to the conspiracy alleged in these contentions, defendants successfully concealed their violations of the Securities and Exchange Act of 1934 and of SEC Rule 10b-5 from the plaintiffs until 1967.

(ee) Each of the defendants participated in concealing those facts and aided and abetted H. R. Watchie and H. R. Watchie & Associates, Inc., in concealing them. The defendants had a fiduciary obligation to disclose all material facts to the plaintiffs at all times while their Cougar Mountain Associates units were subject to annual assessments.

Portion of Page 286 of Transcript of Deposition of H. R. Watchie

"A. I believe what I said, if not I will clarify it, now, that the salesmen were instructed not to hand out written material other than what we had provided them and which had been cleared by the Commissioner's office. They were authorized to quote or to parphrase the information that I had given them, but not to add to it.

Q. When you say the information you had given, you are referring to your afirmative presentation, which you attempted to give from memory at these repeated sales meetings?

A. That's correct."

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JUL 28 1975
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1974

NO. 74-1651

RICHARD A. CLARK, JAMES H. EVANS, WESTON M. LENNOX, DAVID A. MOFFAT, SAMUEL L. SAVIDGE, GEORGE L. ZIMMERMAN and HELEN D. BLOOMFIELD,
Petitioners,

v.

H. R. WATCHIE and SHEILA WATCHIE, his wife, H. R. WATCHIE & ASSOCIATES, INC., a Washington corporation, E. JOSEPH McCAMBRIDGE and JANE DOE McCAMBRIDGE, his wife, GENE LYNN and JANE DOE LYNN, his wife,
Respondents.

BRIEF OF RESPONDENTS LYNN IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

RICHARD A. DERHAM
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IN THE

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OCTOBER TERM, 1974

NO. .....

RICHARD A. CLARK, JAMES H. EVANS,
WESTON M. LENNOX, DAVID A. MOFFAT,
SAMUEL L. SAVIDGE, GEORGE L. ZIMMERMAN
and HELEN D. BLOOMFIELD,
Petitioners,

v.

H. R. WATCHIE and SHEILA WATCHIE, his wife,
H. R. WATCHIE & ASSOCIATES, INC., a Washington
corporation, E. JOSEPH MCCAMBRIDGE and JANE DOE
MCCAMBRIDGE, his wife, GENE LYNN and JANE DOE
LYNN, his wife,
Respondents.

BRIEF OF RESPONDENTS LYNN IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

Respondents Lynn respectfully oppose the petition for issuance of a Writ of Certiorari to review a portion of the judgment and opinion of the United States Court of Appeals for the Ninth Circuit.

OPINIONS IN THE COURTS BELOW

Respondents accept petitioners' statement relating to the opinions below.

JURISDICTION OF THIS COURT

Respondents accept petitioners' statement relating to jurisdiction of this Court.

QUESTION PRESENTED FOR REVIEW

Did the District Court abuse its discretion in denying petitioners' motion that this case proceed as a class action?

RULES AND REGULATIONS INVOLVED

Respondents accept petitioners' statement relating to the rules and regulations involved.

STATEMENT OF THE CASE

Petitioners in 1961 each purchased one or more limited partnership units in a land syndicate named Cougar Mountain Associates. Respondents were associated with the entity that sold those units. Each unit cost Twenty Thousand Dollars. These purchases followed oral sales presentations made at different places and at different times by various salesmen and /or individuals associated with the management of the partnership. There was no written prospectus.

One of the petitioners, James H. Evans, was closely associated with Cougar Mountain Associates and its management, actually assisting in sales efforts. Another of the petitioners, Richard Clark, was an attorney. Another petitioner, Samuel L. Savidge, was the owner of an automobile dealership in Seattle. The background and investment sophistication of the other petitioners also varied. Other investors (the claimed "class") had similarly diverse backgrounds. They included numerous attorneys, stockbrokers, real estate salesmen, and sophisticated investors and businessmen.

Knowledge of the operations of the limited partnership also varied. Some of the investors had purchased units in other similar ventures organized by H. R. Watchie. Some

sold real property to this real-estate syndicate at prices now claimed to have been artificially set. Others were members of land syndicates that sold such property to the limited partnership. Some investors carefully researched the land and the syndicate operations before purchasing. Some relied largely upon H. R. Watchie's opinion in making their decision to purchase.

Pre-purchase communications differed substantially in individual cases. There were a number of meetings of prospective purchasers in which the general partner, H. R. Watchie, or an associate, would make an introductory oral presentation, followed by a question and answer session. Matters discussed at sales meetings would vary according to the knowledge, interests and questions of those involved. Petitioner Evans, for example, attended several of Watchie's sales meetings and testified he was able to learn new things on each occasion about the partnership. At the time he purchased his partnership interest, petitioner Evans was thoroughly knowledgeable about Watchie's operations.

These meetings would often be followed up with personal contacts by salesmen, who were themselves selected in part because of their diverse backgrounds and interests. In some cases there were no such contracts because of the close relationship between Watchie (or someone else involved in the sales) and the prospective purchaser.

The unit salesmen discussed the facts with purchasers and answered questions. Again, no single pattern dominated these sales contacts. Many of the prospective purchasers of units were well aware of the history of sales and resales of property at increasing prices in the general area. Many had intimate knowledge of H.R. Watchie's operation. Discus-

sions with potential purchasers would thus vary according to the information the individual already had.

In 1968, more than seven years after they bought units, the petitioners filed their complaint alleging fraud in the sale of securities. Respondents Lynn were not joined in the action until 1969. In their answers, respondents alleged that the statute of limitations had long since run on petitioners' claims. Petitioners responded that they had not learned of facts which would start the statute running until many years after their purchases. On a motion for summary judgment of dismissal, the court determined that a trial would be necessary to establish exactly when each purchaser had sufficient knowledge of the allegedly undisclosed facts to start the running of the statute of limitations.

The parties commenced discovery under the direction of a special master. Thousands of pages of depositions were taken, with much of the information relating to the class action issue.

Finally in January of 1971 the petitioners moved for a class action determination. But the motion was supported only by a five-page affidavit of petitioners' attorney and a memorandum containing largely conclusory statements about the appropriateness of class treatment. There were no references to the record to support the allegations. Respondents filed numerous affidavits, including those of several salesmen as well as that of H. R. Watchie. These affidavits, together with depositions and exhibits, demonstrated that representations varied significantly from purchaser to purchaser.

After thoroughly considering the affidavits, depositions, pleadings, motions and other papers, the special master

prepared a report containing findings and conclusions recommending against class treatment. Based upon its own review as well as the master's report, the district court found that the individual questions predominated over any common questions. The court therefore denied the motion for a class action.

The petitioners immediately filed a notice of appeal to the Ninth Circuit. Respondents did not object to petitioners taking an interlocutory appeal, but instead indicated that they felt it essential that the matter of class determination be finally resolved as early as possible in the proceedings so that uncertainty relative to the scope of discovery and relevancy of many facts could be avoided. The petitioners chose instead to voluntarily dismiss their appeal. All further proceedings, including discovery, were conducted on a non-class basis.

Thereafter, the district court granted respondents' motion for summary judgment on the basis of the collateral estoppel effect of a prior state court judgment relating to the same transactions. Petitioners appealed that decision to the Ninth Circuit, and at the same time sought review of the district court's decision denying class status. While limiting what plaintiffs could attempt to prove at trial, the court of appeals reversed the summary judgment on collateral estoppel, but affirmed the trial court's decision on this class action issue. Petitioners did not seek a rehearing or clarification by the court of appeals.

It is the Ninth Circuit's affirmance of the class action order that petitioners now seek to have reviewed by this Court.

ARGUMENT

1. The Class Action Determination by the Courts Below Raises No Issue Warranting this Court's Review

Petitioners do not take issue with the Ninth Circuit's recognition that a class-action determination is one of a trial court's considered discretion. Petitioners do not challenge the statement of the court of appeals that a trial judge's findings regarding the provisions of Rule 23 and their application to the case should be considered to be within his discretion.

Instead, petitioners in essence argue that the contentions which they made should have controlled the trial court's decision. In effect, petitioners' principal argument is that the trial judge's discretionary determination was wrong.

This argument simply raises an issue of fact which would require a detailed analysis of the record presented to the trial court. This Court pointed out in *United States v. Johnson*, 268 U.S. 220, 227 (1925): "We do not grant certiorari to review evidence and discuss specific facts."

Throughout this extended litigation, petitioners' class-action arguments have been based upon their contentions of facts rather than upon evidence of such facts. Even in their petition for certiorari, petitioners rely principally on what they "expect to prove" (pages A42-A57 of petitioners' appendix) and upon their "disputed contentions in the pretrial order" (pages A57-A70 of petitioners' appendix). Of course, a party's contentions cannot, without more, serve as a basis for class treatment. Plaintiffs have the burden of proof with respect to each of the requirements of Rule 23. *Cf. e.g., DeMarco v. Edens*, 390 F.2d 836 (2d Cir. 1968); *Poindexter v. Teubert*, 462 F.2d 1096 (4th Cir. 1972).

Without the imposition of this burden a plaintiff would always gain class-action treatment simply by alleging the existence of common questions of law or fact.

When, as here, there is disagreement between the parties as to the facts, the trial court must consider the entire record as presented at the time the motion for class determination is made. Here the trial court had before it affidavits which flatly contradicted petitioners' unsupported contentions, demonstrating that there were few, if any, common questions and that individual questions predominated in the litigation. The special master and the district court judge also had before them thousands of pages of deposition transcripts as well as numerous other affidavits and papers relative to other aspects of the case, which would have to be considered in a review court. The trial judge was well aware of petitioners' contentions of nondisclosures and conspiracy.

The trial court correctly recognized that statements made or not made in connection with sale of the units would vary in the case of every sale. In addition, individual fact questions relative to the statute of limitations, estoppel and waiver, damages, and reliance upon affirmative representations,[1] also militated against class treatment. It

1. Petitioners state at pages 16-17 of their Petition that there would be an issue at the time of trial as to "which, if any, of the statements in the printed copies of the partnership articles were false?" Examination of the pre-trial order, however, shows that petitioners have not alleged that any of the statements in the partnership articles were false. If, despite the pre-trial order, petitioners were permitted to make such an allegation, this would raise at least two questions that would require individual analysis. The first would be whether or not each purchaser received prior to his purchase a printed copy of the partnership articles. According to his sworn testimony, petitioner Evans did not. The second question would be whether there was reliance upon any such positive misrepresentations by the petitioners or other purchasers in making their decision to purchase.

seems apparent that this Court should not direct its attention to the claim that the district court erred in analyzing the record. This issue, which would require review of factual determinations by the trial court in light of an extensive record, is not sufficiently important to warrant the Court's attention.

2. Rule 23 Clearly Requires a Finding That Common Questions Predominate. There is No Need for this Court to Issue an Opinion on that Portion of the Rule

Petitioners contend that the Ninth Circuit has added an additional requirement with respect to class action suits under Rule 10b-5 by requiring proof in this case that misrepresentations or non-disclosures were common to the class. Petitioners contend further that this raises an important question of federal law, requiring settlement by this Court. Neither contention has merit.

The ostensibly new class action requirement is, according to petitioners, contained in the language of the opinion quoted at the top of page 9 of the petition for certiorari. As quoted, the language reads:

> Appellants must show, as a condition to class status, that any misrepresentations or non-disclosures were common to the class. They have not shown that the alleged misrepresentations and nondisclosures involved every limited partner.

But the opinion is incompletely quoted. Without noting the deletions, petitioners have left out parts of the quoted sentences, and have also deleted reference to footnotes 13 and 14. The full paragraph, together with the explanatory footnotes, appears as part of the extract from the court's opinion on page A-1-2.

Moreover, when read in context with what precedes and follows the quoted language, it is apparent that the Ninth Circuit was responding to a specific argument of petitioners relating to the predomination requirement. The court simply recognized that even though petitioners might not have to establish reliance in this case (which would raise individual questions) there were still other impediments to class treatment, in particular the failure to show that all the limited partners were victims of the same alleged misrepresentations or nondisclosures. The trial court had found that common questions did not predominate. In the quoted langague, the court of appeals was discussing the trial court's finding and, in footnote 14, the court specifically referred to the predomination requirement by pointing out that appellants had the burden of proof on that issue.

This did not impose any "new" requirement with respect to class action suits. It has always been clear under Rule 23 that one party can represent all others in a purported class action only if that party can show first that in some respects at least his experience or claims are common to all. There is nothing new in such a requirement. The existence of common questions in any purported class action is a specific prerequisite to class treatment according to subsection (a)(2) of the rule.

But even a showing of common questions will not resolve the class issue, for under subsection (b) (3) of the rule there must be a finding that any such common questions of fact or law predominate over any questions affecting only individual members. The Ninth Circuit is thoroughly familiar with these requirements of Rule 23 and has applied them correctly. *See, e.g., Kline v. Coldwell Banker*

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& *Co.*, 508 F.2d 226 (9th Cir.), *cert. denied*, No. 74-1196 (May 12, 1975); *In re Hotel Telephone Charges*, 500 F.2d 86 (9th Cir. 1974); *LaMar v. H.B. Novelty & Loan Co.*, 489 F.2d 461 (9th Cir. 1973).

The trial court in this case found that the sales presentations made by defendants were oral and the statements made or not made will vary in each case. The court therefore concluded that the required predominance of any common questions was absent in this case. The Ninth Circuit affirmed that ruling, recognizing that the trial court applied the proper rule of law and that its determination of class status is a proper exercise of its discretion.

There is no merit to the assertion that this application of the commonality requirement by the trial court, which was affirmed by the Ninth Circuit, threatens effective enforcement of the securities laws. The Ninth Circuit has been very protective of rights under Rule 10b-5, holding that in some circumstances, depending upon the relationship of the parties, mere negligence may be sufficient to justify imposition of liability under the rule. *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974). When sales are accomplished through standardized means, such as through a written prospectus, then class-action status may be appropriate. But when, as here, there is little standardization, and any questions common to the purchasers do not predominate over individual questions, then remedies under the securities laws must be pursued on an individual basis.

3. There is No Conflict With the Decision of the Tenth Circuit in *Esplin v. Hirschi*

The Tenth Circuit, like the Ninth, will normally defer to the judgment of a district court in determining whether

a suit should be maintained as a class action. *Wilcox v. Commerce Bank of Kansas City,* 474 F.2d 336 (10th Cir. 1973).

At pages 12 through 13 of the petition, it is claimed that the decision of the Ninth Circuit conflicts with the Tenth Circuit's decision in *Esplin v. Hirschi,* 402 F.2d 94 *cert. denied,* 394 U.S. 928 (1968). Examination of the decision in *Esplin v. Hirschi* shows, however, that there were substantially different facts in the case. There the defendants admitted various nondisclosures. Certain omissions of material facts were "common to all purchasers." But more significantly, in addition to the 10b-5 claims *Esplin v. Hirschi* involved an alleged failure to comply with the Investment Company Act (a fact which is not even mentioned by the petitioners). The Tenth Circuit recognized that questions under that Act were identical as to each and every member of the class. Thus, the court stated, 402 F.2d at 99:

> Hence, while the propriety of allowing a class action on the 10b-5 count is an extremely close question, there is really little doubt, as to the Investment Company Act, that the common issues predominate. Consequently, there does exist as to the totality of issues a common nucleus of operative facts such as would justify allowing the class action to proceed under newly amended Rule 23.

There is no Investment Company Act claim in the instant case.

Because of these major differences in the facts and the legal issues involved, the Tenth Circuit's decision in *Esplin v. Hirschi* gives little guidance here. It certainly does not represent a conflict with the decision of the Ninth Circuit.

4. There is No Conflict in Principle With Decisions of the Second Circuit

There is no conflict in principle between the decisions of the Second and Ninth Circuits on the issues involved in this case.

The Second Circuit, like the Ninth and Tenth, normally defers to the judgment of a district court in determining whether a suit should be maintained as a class action. *City of New York v. International Pipe and Ceramics Corp.*, 410 F.2d 295 (2d Cir. 1968).

Furthermore, the Second Circuit, like the Ninth and Tenth, recognizes that the matter of communication between seller and purchaser may have great bearing on whether a class action is appropriate. The court in this case cited *Moscarelli v. Stamm*, 288 F. Supp. 453 (E.D.N.Y. 1968) and *Simon v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 482 F.2d 880 (5th Cir. 1973) in pointing out that oral misrepresentations lead to individual questions because they are not standardized in the same sense as misrepresentations in a prospectus or financial statement. The Second Circuit recognized this same distinction in *Korn v. Franchard Corp.*, 456 F.2d 1206 (2d Cir. 1972). The court there observed that the pre-condition of commonality was satisfied by a prospectus which related to all investors. *Id.* at 1210. It went on to distinguish cases involving such common questions from *Morris v. Burchard*, 51 F.R.D. 530 (S.D.N.Y. 1971), pointing out at note 20 that *Morris v. Burchard* involved oral misstatements which were not standardized and which did not emanate from a single course of conduct.

Green v. Wolf Corp., 406 F.2d 291 (10th Cir. 1968), *cert. denied*, 395 U.S. 977 (1969), is also consistent with

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the Ninth Circuit's ruling. The Second Circuit in that case agreed with the assertion that misstatements and omissions were present in all prospectuses, and the commonality requirement was thus satisfied. The Ninth Circuit discussed this exact point in footnote 13. As the court pointed out, a standardized prospectus could be assumed to have been received by all class members, thus justifying class treatment. The court observed, however, that a similar assumption could not be made on the facts of this case.

Petitioners cite *Competitive Associates, Inc. v. Laventhol, Krekstein, Howarth & Howarth*, C.C.H. Fed. Sec. L. Rep. ¶ 95,090 (2d Cir. 1975), as conflicting in principle with the decision by the Ninth Circuit. But that case did not involve a class-action question. The issue there was whether proof of direct reliance on false financial statements was necessary for recovery under Rule 10b-5. The Second Circuit rejected defendants' argument that because the case involved allegations of misrepresentation as opposed to non-disclosure the plaintiff had to show reliance in addition to causation in fact. Again, there is no conflict in principle with the Ninth Circuit's opinion. The circuit court in this case stated that although petitioners might not have to establish reliance in order to recover, this was not the essential issue relative to the class action.

CONCLUSION

This Court should deny the petition for a writ of certiorari.

Petitioners contend that there are two questions worthy of review. First, they ask whether there may "be a class action on behalf of all defrauded investors provided that the common issues predominate over the individual issues" although certain facts are not established to be identical

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as to each investor. Certainly a class action may be allowed under such circumstances. Reference to the wording of Rule 23 makes it apparent that not *all* issues need be common to the class; rather, the requirement is that common issues must *predominate* over individual issues. Neither the Ninth Circuit nor the district court misperceived nor misapplied this rule. The district court found, on the basis of an extensive record, that common questions did not predominate over individual questions. Thus, it correctly found that the case was not appropriate for class treatment. The Ninth Circuit properly affirmed that decision.

Secondly, petitioners ask whether Rule 23 gives a district court the discretion to deny class status to a suit if there are common questions of law and fact that predominate over individual questions, merely because securities were sold with oral representations. Regardless of how that question is resolved, it is not relevant to this case. The question assumes that there are common questions of law and fact that predominate. Once again, however, that is not the situation in this lawsuit.

Despite their attempts to characterize the issues involved as important, novel, and unsettled in a manner demanding this Court's attention, petitioners' actual grievance is with the exercise of discretion by the trial court. That court properly exercised its discretion within the confines of Rule 23, and the Ninth Circuit affirmed that exercise after due consideration of whether or not the trial court had acted propertly. There is no need for this Court to review that decision.

Respectfully Submitted,

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APPENDIX

Portion of Ninth Circuit's opinion, *Clark v. Watchie*, 513 F.2d 994, 999-1000 (9th Cir. 1975):

The district court adopted the special master's report without extensive comment. The report stated that none of the Appellees made written representations to the purchasers of limited partnership units. The master reasoned that since the alleged omissions and misrepresentations were oral, separate determinations would have to be made of what was disclosed to each limited partner. He concluded that questions of law or fact common to the members of the class do not predominate over questions affecting only individual members.

Appellants contend that we should hold that common questions predominate. They reason that it is important that the presentations of some salesmen may have differed from others only if the element of reliance is a prerequisite to ultimate liability. In support of their contention that reliance is not an element in a 10b-5 suit, Appellants cite Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-154, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972). There the Supreme Court said that "positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of the decision."

In so arguing, Appellants misconceive the issue. Although they might not have to establish reliance to ultimately succeed in the suit, Appellants must show, as a condition to class status, that any misrepresentations or non-disclosures were common to the class.[13] They have not done so for they have not shown that the alleged misrepresentations and non-disclosures involved every limited partner.[14]

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13. In this connection, the Second Circuit case, Herbst v. International Telephone and Telegraph Corp., 495 F.2d 1308 (2nd Cir. 1974), is inapposite. The Court held that since individual reliance was not an element, the district court did not err in holding that common issues of law and fact were predominant. In ***Herbst***, the alleged misrepresentations were issued through a written prospectus. In certifying the suit as a class action, the district judge could have assumed that all class members received the standardized prospectus. A similar assumption cannot be made in this case. Furthermore, other courts have held that oral misrepresentations lead to individual questions because they are not standardized in the same sense as misrepresentations appearing in a prospectus or financial statement. See Moscarelli v. Stamm, 288 F.Supp. 453, 462 (E.D.N.Y. 1968); Simon v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 482 F.2d 880, 882 (5th Cir. 1973).

14. Appellants have the burden of showing that common questions predominate. Cf. Poindexter v. Teubert, 462 F.2d 1097 (4th Cir. 1972).

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In the Supreme Court

of the United States

OCTOBER TERM, 1974

No. 74-1651

RICHARD A. CLARK, JAMES H. EVANS, WESTON M. LENNOX, DAVID A. MOFFAT, SAMUEL L. SAVIDGE, GEORGE L. ZIMMERMAN and HELEN D. BLOOMFIELD,
Petitioners,

v.

H. R. WATCHIE and SHEILA WATCHIE, his wife, H. R. WATCHIE & ASSOCIATES, INC., a Washington corporation, E. JOSEPH McCAMBRIDGE and JANE DOE McCAMBRIDGE, his wife, GENE LYNN and JANE DOE LYNN, his wife,
Respondents.

PETITIONERS' REPLY BRIEF

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PETITIONERS' REPLY BRIEF

ERRORS IN PETITION FOR CERTIORARI

Petitioners' attorney apologizes for error in the quotation from the opinion of the court of appeals which appears in the petition for certiorari. It should have read:

> "Appellants must show, as a condition to class status, that any misrepresentations or non-dis-

closures were common to the class. *They have not done so for* they have not shown that the alleged misrepresentations and non-disclosures involved every limited partner."

The quotation appears in the petition as a new paragraph and the words set out above in italics were omitted. The latter error apparently occurred because the first three words of the missing phrase are the same as those which follow it.

Petitioners' attorney has no excuse for his failure to find and correct those mistakes. The quotation was correctly set out in the copy sent to the printer, but the errors appeared in the proofs submitted by the printer. They should have been found and corrected by the author. Fortunately the mistakes do not appear to change the holding of the Court of Appeals.

NO BRIEF OF RESPONDENTS OTHER THAN LYNN

Respondents Lynn have filed a brief in opposition to the petition for writ of certiorari. Petitioners are advised that no other respondent will file a brief.

ARGUMENT IN REPLY TO LYNN BRIEF

The Lynn brief hints, but does not directly assert, that some of the class members were aware of the facts about the alleged scheme to defraud. Lynn cannot say that. The investors could not have known of an artificial market in real estate, of a real estate bub-

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ble about to burst, or of a scheme to sell the properties of earlier investors to the new syndicate at excessive prices if Lynn is correct in contending that those things never existed.

Faced with this dilemma Lynn came as close as he could to alleging individual knowledge of those things by some of the investors. At page 3, the Lynn brief asserts that "petitioner Evans was thoroughly knowledgeable about Watchie's operations."

The fact is that Evans was employed as a salesman selling residential lots in a Watchie subdivision. He demonstrated his ignorance of the facts about the venture by investing $80,000 in it and by recommending it to his friends. No one would have invested in the partnership if the artificial market, the real estate bubble and the scheme to defraud did in fact exist, and were known to the investors when they were asked to purchase partnership units.

Lynn's brief states (p. 2) "Some of the investors had purchased units in other similar ventures organized by H. R. Watchie." There was no other similar venture.

At page 4 respondent Lynn asserts that in denying a motion for summary judgment "the court determined that a trial would be necessary to establish exactly when each purchaser had sufficient knowledge of the allegedly undisclosed facts to start the running of the statute of limitations." The pertinent determination was made by the special master. He found that the statute of limitations against respondent

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Lynn did not begin to run until his participation in the alleged scheme to defraud was brought to light by extensive discovery proceedings in this action (A-34). That finding was adopted in full by the district court.

In an extensive footnote at page 7 of the Lynn brief, there is an assertion that the pretrial order makes no claim of any false statements in the printed partnership articles. The pretrial order asserted (A-65) that there was a false representation that no property would be purchased by the partnership if Watchie or his related persons or interests owned an interest of 10% or more, unless the price paid was justified by two out of three separate MAI appraisals of each property. That allegedly false representation was made in those printed articles, which were used as the prospectus and distributed to all prospective purchasers of units.

The Lynn brief, and the decision of the court of appeals, assume that there should be no securities fraud class action unless the plaintiffs can establish that any misrepresentations and concealments were identical for each purchaser (A-16, Lynn Br. 9). That is not a proper application of the class action rule to many suits for alleged securities fraud. Where, as here, there is a single scheme to defraud, with a common core of fraudulent conduct, and the questions of law and fact that are common to all members of the class clearly predominate over questions effecting only individual members, a class action should be permitted. It is an abuse of discretion for a trial court to

deny class status to an appropriate action where common issues predominate, even if the suit is under S.E.C. Rule 10b-5 and the representations made to some investors were not identical to those made to others.

Lynn's position, at page 9 of his brief, that plaintiffs must "show that all the limited partners were victims of the same alleged misrepresentations or nondisclosures" is not reasonable. Common issues must predominate if class actions are to accomplish their intended purpose. It does not follow that those who sell securities by fraud should be permitted to insulate themselves against the only ordinarily effective private civil remedy by using some varying representations in carrying out their schemes to defraud. The trial court's consideration should not be limited to the presence or absence of identical representations to all investors. The court should instead find if common or individual questions of law or fact predominate when all aspects of the pending action are considered.

CONCLUSION

The Lynn brief demonstrates no good reason for denial of the petition for a writ of certiorari.

Respectfully submitted,

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